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UNITED STATES TRADE AND COMPETITIVENESS

HEARINGS

BEFORE THE

SUBCOMMITTEE ON ECONOMIC STABILIZATION

OF THE

COMMITTEE ON
BANKING, FINANCE AND URBAN AFFAIRS
HOUSE OF REPRESENTATIVES

NINETY-NINTH CONGRESS

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THE TRADE DEFICIT

TUESDAY, APRIL 16, 1985

House of Representatives,
Subcommittee on Economic Stabilization,
Committee on Banking, Finance and Urban Affairs,
Washington, DC.

The subcommittee met at 10:45 a.m., in room 2128, Rayburn House Office Building, Hon. John J. LaFalce (chairman of the subcommittee) presiding.

Present: Chairman LaFalce, Representatives Vento, Cooper, Kaptur, and Carper.

Chairman LaFalce. The Subcommittee on Economic Stabilization will come to order.

Last year, this country's trade deficit set an extraordinary record, soaring to $123.3 billion—almost twice the previous record set in 1983 and three times the 1982 trade deficit. We face yet another recordbreaking year—some analysts project this year's trade deficit will rise as high as $150 billion.

In contrast to the past, our merchandise trade deficit is no longer offset by either capital or service flows. Instead, these areas are also deteriorating. The surplus in American sales of services—insurance, banking, engineering, advertising, and the like—declined last year for the third year in a row. The 1984 current account deficit—which includes trade in merchandise and services, as well as financial flows between Americans and residents of other countries, reached over $100 billion last year, up from $41 billion in 1983.

The magnitude of these figures is truly alarming. Trade deficits on this scale are unprecedented in our economic history, and no one can really forecast what the full effect will be. We only know they can't last for long.

The trade deficit is already destroying industries that rely heavily on exports such as agriculture and those such as steel, autos, machine tools, and textiles that face severe competition from imports, while devastating the regions of this country in which these industries are based.

The erosion of industries that produce capital goods, the driving force of our past economic expansion, is particularly ominous. Last year the capital goods sector provided the biggest increase in U.S. imports, up a substantial 46 percent or $19 billion, depriving American machinery makers of the fruits of the Nation's capital goods boom. Exports of construction equipment dropped 63 percent between 1981 and 1983, and shipments of machine tools were down 60 percent.

Still more startling, imported equipment increasingly represents the most advanced areas of technology, Trade statistics indicate that the United States is losing its supremacy in high-technology goods. Our trade surplus for these products, including computers and telecommunications equipment, dropped from $25.5 billion in 1980 to $17 billion in 1983.

The trade deficit is rapidly changing the way American firms are doing business, driving more of them abroad and increasing the amount of outsourcing. Much of the capital equipment we are importing is being produced abroad by American companies with American technology and management but foreign labor. Once such a pattern is established, it is likely to endure.

The toll must be measured not only by layoffs and plants closed, but also by job opportunities lost and factories never built. As many as 3 million Americans in export and importing competing industries will be unemployed by late 1985, as the result of this deterioration of American industries. We are exporting a large fraction of our growth potential, improving the position of foreign firms and foreign workers, instead of stimulating our domestic economic growth. The soaring trade deficit could lower this year's growth in the gross national product by as much as 1 percent.

The causes of our burgeoning trade deficit are complex and administration response simplistic or ineffective. The high dollar which the administration praises as a sign of faith in the U.S. economy actually reflects the destabilizing influence of record budget deficits. This high dollar is also the uncompetitive dollar and bears a major portion of the blame for our trade deficit.

The dollar's value has soared 40 percent since 1980. The result has been to make foreign goods less expensive in the United States, flooding the United States with imports, and increasing the price of U.S. products in overseas currencies, making them less competitive.

This flow of artificially cheap imports undercuts American manufacturers' sales in their home market and acts to hold down the rate of economic growth.

Despite the dollar, substantial cuts could be made in the deficit if American companies had equal access in foreign markets where American exporters face complex official and informal barriers.

Japan, which last year accounted for $36.8 billion of the record $123.3 billion U.S. trade deficit, is the prime example. But extensive administration negotiations in a number of sectors have elicited only one more Japanese market opening package, again accompanied by no specific commitments that hold out the promise of actual increased sales.

Clearly, we must act aggressively to reduce Japanese market access barriers, but we must also shoulder our own share of blame for our competitiveness problems. The administration itself acknowledges that if we were to take away all barriers to the Japanese market, and push the yen to a sharply higher level against the U.S. dollar, the United States would still run a substantial trade deficit with Japan. The fact is that deficits with virtually all our trading partners are growing.

We simply cannot sustain trade deficits of the magnitude we are currently running. Our standard of living will begin to decline as more and more foreign capital is needed to finance our trade deficits. As of the first quarter of this year, it was estimated that the United States already owes more than it has assets overseas, making us a debtor Nation for the first time since World War I.

The administration has manufactured a recovery paid for with record budget deficits and high interest rates. A burgeoning trade deficit is also part of the package. The long-range damage it can effect, resulting from lost markets and increased reliance on foreign goods, could easily wipe out its illusive benefits.

In order to discuss this entire range of issues, we are pleased today to have with us the following witnesses to help us explore them: Geza Feketekuty, Senior Assistant U.S. Trade Representative; Richard Heckert, vice chairman of the Du Pont Corp.; Lawrence Fox, vice president of the international department of the National Association of Manufacturers; and Ronald Danielian, president of the International Economic Policy Association.

I know that the representative from Du Pont is a corporate constituent and perhaps a personal constituent of Representative Carper. I wonder if Representative Carper would like to make any comments before we proceed.

Mr. **Carper**. I think I will defer my comments. I appreciate very much the opportunity to do so. I would like to have a chance to introduce Mr. Heckert. And I just would like to say to the chairman that I think these hearings are timely. The panel that you have assembled before us is quite a good one, and I look forward to their testimony.

Chairman **LaFalce**. Thank you. Our first witness will be Mr. Feketekuty. We look forward to hearing from you again.

I advise all the panelists that we have the entire text of your remarks. They will be incorporated in the record, and we would ask that you summarize them.

STATEMENT OF GEZA FEKETEKUTY, SENIOR ASSISTANT U.S. TRADE REPRESENTATIVE FOR TRADE POLICY AND DEVELOPMENT, OFFICE OF THE U.S. TRADE REPRESENTATIVE

Mr. **Feketekuty**. Thank you, Mr. Chairman. I am delighted to see you again after our last little debate.

Chairman **LaFalce**. Colloquy.

Mr. **Feketekuty**. Colloquy. [Laughter.]

As you suggested, I have prepared a very short summary of my comments. I have a much longer statement that I have prepared. I would like to briefly summarize our views on the trade deficit, what caused it, what its effects are and what we can do about it.

Clearly, as you have said, we cannot sustain the kinds of deficits we have had in the last year or two, and we have to address this problem very seriously,

The increased trade deficit is largely a result of global macroeconomic forces beyond the control of trade policymakers either in the United States or abroad. And that is a real dilemma that we face in the trade area, that it creates tremendous pressures for trade policy remedies that could unravel the open trading system, while really no trade policy remedy is capable of correcting the underlying macroeconomic imbalances that caused the deficit in the first place, and no amount of effort in the trade policy area is going to make a significant dent in the overall deficit.

The principal causes of the trade deficit are the debt crisis in the developing countries, the more rapid economic growth in the United States than in other parts of the world, and a large increase in capital inflows which has forced up the value of the dollar.

Our guess is that the rise in the value of the dollar accounts for about half of the $80 billion increase in the deficits from 1982 to 1984.

There has been a great deal of discussion whether the large capital inflows are the result of relatively faster growth in the United States than in the rest of the world or the relative availability and cost of money in the United States and elsewhere. In my mind, it is clearly the result of both.

Fundamentally, the trade deficit reflects a gap between domestic savings and investments. During 1983 and 1984 U.S. domestic investment increased by nearly $225 billion, while net U.S. savings increased by only $145 billion. The $80 billion gap between the two was covered by a $85 billion increase in the current account. The $5 billion difference is due to statistical discrepancies. We had an increase in the Government's demand for savings, as well as a very, very large increase in private demand for savings, and the domestic economy just did not generate savings at that level. So the difference was made up by inflows of foreign savings through capital inflows.

The second most important cause of the trade deficit has been the debt crisis in many developing countries, which has forced these countries to cut back on their imports and encouraged them to redouble their efforts to export.

The U.S. trade balance with the nonoil developing countries deteriorated by $27 billion between 1982 and 1984. That is almost one-third of the deterioration in the trade deficit during those 2 years. The U.S. trade balance with the six Latin American countries suffering from high debt burden deteriorated by $11 billion.

The third cause of the U.S. trade deficit is the slow growth in Europe and elsewhere, which has kept U.S. exports relatively flat. If one looks at the relative impact of imports and exports in the trade deficit, one will probably come up with the conclusion that the failure of our exports to increase as one might have expected them to, has been the greater contributor to the deficit than has been the increase in imports.

A fourth cause of the deficit are some increases in import restrictions and export subsidies and clearly, the relatively low level of manufactured imports in Japan. Japan is clearly not absorbing the level of manufactured imports that they would be expected to absorb in light of its own growth.

Having said that, though, I think we should be very clear that No. 1, the changes in trade barriers had only minimal effect on the $90 billion deterioration over the last 2 years. The barriers that we face have been there for a long time and are not something that has happened over the last few years. Similarly, with many of the export subsidies, they have been there for some time and are not the result of changes in the last 2 years.

Now one can still say, even though the deficit did not significantly increase over the last 2 years as the result of trade barriers or subsidies, that the reduction of barriers or reduction in subsidies could nevertheless help us in leveling off the balance. But even, as you suggested, Mr. Chairman, under the best of circumstances, if we were able to eliminate all of the foreign restrictions and subsidies, it would only reduce a fraction of the overall trade deficit that we have.

Somebody has suggested that if the Japanese eliminated all their restrictions, at best we would be able to increase our imports by about $10 billion, that compared to $120 billion of trade deficits. So clearly, the major causes lie elsewhere and the major remedies have to be looked for elsewhere.

In terms of the effect this has had on us, there clearly has been some concern because of the effect it has had in our asset position, and there is concern that this is mortgaging our future, that we cannot sustain deficits of this kind without clearly building up a very large claim against our future standard of living, but what really causes problems is not this overall effect, but it is the uneven effect on different industries.

If all industries were equally affected, any job losses associated with the trade deficit could be offset by expansionary domestic economic policies. Our problem is that increases in imports have been particularly large in individual industries already under a great deal of pressure from long-term shifts in the world economy. Thus, while overall imports grew by 34 percent over the 2-year period, textile imports grew by 69 percent. Nonferrous metal imports grew by 58 percent and chemical imports grew by 62 percent and electrical machinery imports grew by 77 percent. Clearly, there is a difference here between the average increase in imports and exports, increases in specific industries that have long-term problems for adjustment.

Similarly, the decline in exports was particularly severe in industries experiencing other problems. Thus, while overall U.S. exports grew by 3 percent, which is clearly subnormal by itself, exports in other industries experienced significant declines. Exports of wheat, for example, fell by 1 percent, which relates back to the serious problems we are experiencing in our farm sector.

Exports of construction machinery declined by 33 percent, which at least explains, in part, the difficulties of companies like International Harvester and Caterpillar. And exports of metal cutting machine tools declined by 39 percent.

So here again, we have a significant sectoral effect, which cannot easily be offset by overall macro policies.

While the U.S. economy overall grew by 6.8 percent last year, many of the sectors impacted by increased imports and decreased exports had a relatively weak recovery from the 1980–82 recession. Now most of these industries did improve their position but not by as much as our economy as a whole. It is in this relative difference that the explanation lies for concern expressed by these industries. One can certainly see that when one looks at the table of average capacity utilization, average increases in employment and output and compares that to capacity utilization and employment and output figures for specific industries.

I have a table like that in my prepared statement, which I have made available to the subcommittee.

There has also been a particularly heavy effect on corporate profits in these industries, and there is a long article in the latest issue of "Fortune" that explains that in great detail.

Industries impacted by particularly large volumes of low-priced imports, not surprisingly, have come to us seeking import restraints, and they have made similar requests to the Congress, as I am sure you are aware. At the same time, many export industries that have traditionally provided strong support for U.S. trade policies have become too preoccupied with their internal problems to provide effective support for our more market-oriented trade policies.

This situation is putting a difficult strain on U.S. trade policies.

If the only problem in world trade were the U.S. trade deficit, the constraints on U.S. trade policy would be less serious. Unfortunately, other countries are having equally serious trade problems. The world trading system has been under considerable strain for a number of years as a result of the global recession, the debt crisis in the developing countries after a long period of slow growth in Europe, and long-term shifts in the world economy.

The net result has been that most trading countries are experiencing protectionist pressures, not just the United States and Government intervention has increased significantly in key industries globally. Now that Government intervention in the rest of the world feeds back and creates further problems for us.

In fact, some of the more recent decisions to restrain imports were largely triggered by this growing Government intervention abroad. I am referring specifically here to what happened in the steel sector.

In this environment, the world trading system desperately needs and expects effective U.S. leadership, and that is made all the more difficult by the deficit and the kind of situation we're facing.

There are no easy short-term fixes for the imbalance in U.S. trade. What is needed are policies that will reduce the budget deficit, boost domestic savings, particularly through tax reform, and stimulate growth in the rest of the world.

I say that not in trying to excuse trade policy. I do think that in a trade area, we must continue to make major efforts to reduce foreign trade barriers and subsidies and other unfair trade practices. But we have to be clear that no amount of effort here in the trade area is going to solve the underlying problem, which is a macroeconomic problem.

Thank you, Mr. Chairman.

[The prepared statement of Mr. Feketekuty follows:]

WRITTEN STATEMENT OF SENIOR ASSISTANT U.S. TRADE REPRESENTATIVE GEZA FEKETEKUTY BEFORE THE HOUSE BANKING COMMITTEE; SUBCOMMITTEE ON ECONOMIC STABILIZATION

APRIL 16, 1985

"THE U.S TRADE DEFICIT"

I am pleased to be with you today to discuss the U.S trade deficit. I will focus my remarks on the causes and consequences of the deficit and what it means for our trade policy.

In 1984, the United States ran a merchandise trade deficit of $123.3 billion as compared to $42.7 billion in 1982. The shortfall may rise even higher next year, to perhaps $140-$160 billion. A billion dollars is a difficult figure to comprehend. To put the size of the trade deficit into perspective, our trade imbalance in 1984 was larger than the gross national products of numerous countries, including Saudi Arabia and Sweden. As the late Senator Everett Dirksen once said, a billion here and a billion there and pretty soon you are talking about real money.

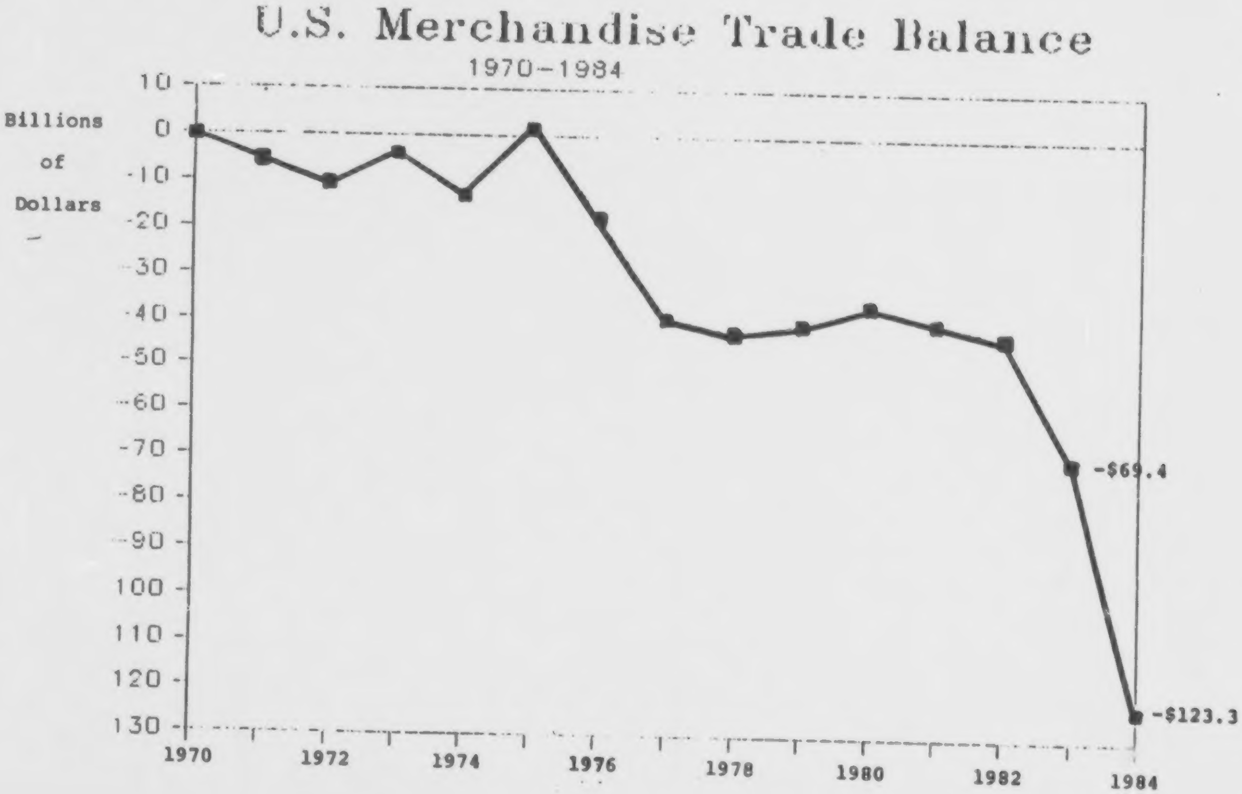
The trade deficit is the cause of much concern within and outside government. The United States cannot import half again as many goods as it exports for a prolonged period without running into difficulties. The deterioration in America's trading position has caused much pain, particularly to those sectors of the economy that depend on exports for their prosperity as well as on import-sensitive industries.

As domestic economic growth and demand slow from the torrid pace set in 1984, trade-sensitive firms are likely to be hit even harder as fewer opportunities exist within the United States to offset sales lost to foreign producers. For example, textile industry profits, which recovered substantially in 1983, fell throughout 1984 as imports increased. Nearly half the growth in domestic demand from the first to the second half of 1984 was met by imports. As the growth rate of U.S. demand slows with the maturing of the recovery, the trade imbalance may critically affect our industry's ability to expand output and employment.

What is the Problem?

In 1983, the United States ran a then record merchandise trade deficit of $69.4 billion, up from $31.8 billion in 1982. The 1984 trade deficit showed a significant worsening, increasing to $123.3 billion or almost double 1983's record. As shown in Figure 1, while the United States has run a merchandise trade deficit for most of the past 15 years, it is only in the past two years that the deficit has taken a sudden plunge. The 1984

FIGURE 1



U.S. Merchandise Trade Balance

1970–1984

deficit reflects a continuation of two trends that began in 1983: a massive increase in demand for imports in the United States and a far weaker foreign demand for American exports. Imports surged by 26 percent from their 1983 level, while U.S. exports increased by only 9 percent.

A more accurate measure of America's trade performance than the merchandise trade balance is the current account balance. The merchandise trade balance focusses on trade in goods: agriculture, manufactures, mining and petroleum products. Yet a large part of U.S. output and an important positive component in our international transactions is accounted for by services. The current account balance includes the merchandise trade balance plus trade in services and returns on U.S. investment overseas.

Therefore, a more appropriate gauge of our trade position is the broader measure of our international dealings, the balance on current account. As with the trade position, there is no inherent need for the current account to be balanced, and, indeed, it usually is not. Figure 2 shows how the U.S. current account has fluctuated between surplus and deficit since 1970. The burgeoning merchandise trade deficit has caused our current account to plunge deeply into deficit since 1982, with 1984's current account deficit of $102.3 billion breaking 1983's record of $41.6 billion.

It has been pointed out that the import penetration ratio, imports as a percentage of GNP, is less than it was in 1980. True, in nominal terms the import penetration ratio was 9.8 percent in 1980 and was 9.3 percent in 1984. These figures are misleading, however, because they consider the value of trade, not the volume. To illustrate how these figures can be distorted, assuming no growth in nominal GNP between 1980 and 1984, if import prices fell by one-half during that period, the volume of U.S. imports could have doubled without any change occurring in the import penetration ratio.

A more meaningful measure of the shift in imports is how the volume of imports has increased relative to the real change in GNP. (See Figure 3) While real GNP growth was only 11.2 percent between 1980 and 1984, the volume of our merchandise imports in real terms has grown by over 40 percent and our manufactures imports by 70 percent. In contrast, as Figure 4 shows, our export volumes have declined substantially since 1980. Merchandise exports are down about 14 percent and manufactures exports have fallen by about 19 percent.

Why Should We Worry About the Trade Deficit?

What reasons are there, if any, to be concerned about the trade deficit? Granted, the deficit is extremely large, but our

FIGURE 2

U.S. Current Account Balances, 1970–84

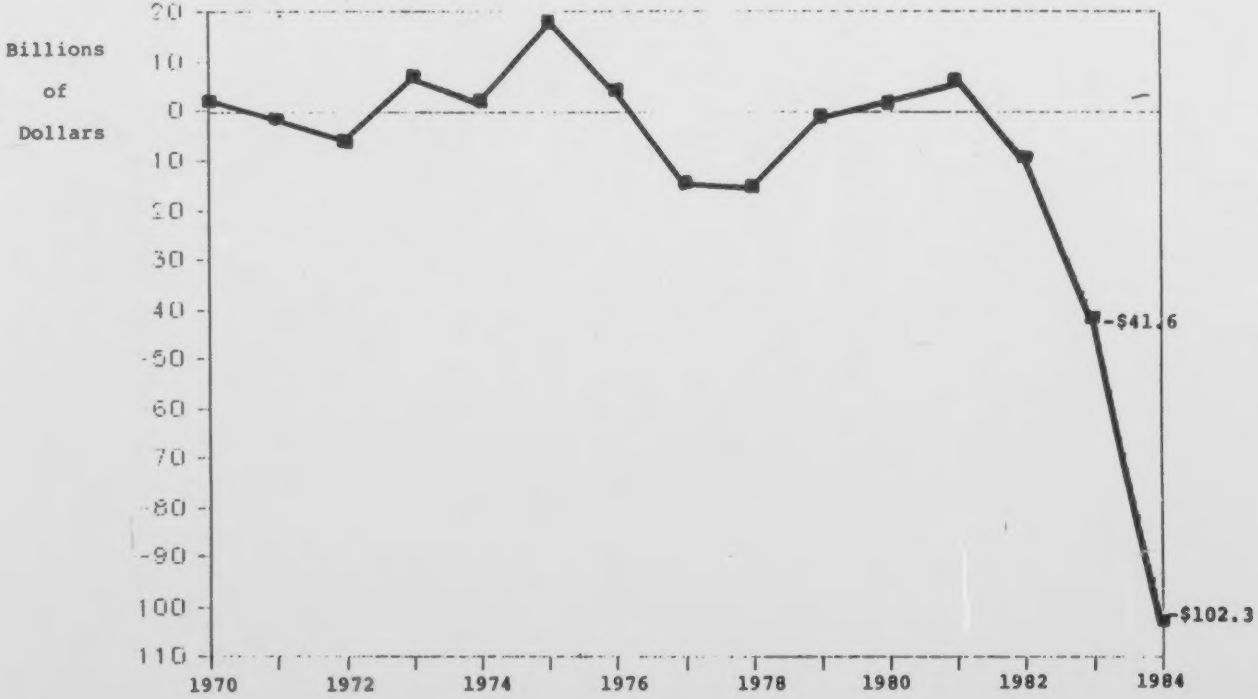


FIGURE 3

REAL CHANGES IN U.S. GNP, MERCHANDISE IMPORT VOLUME, AND MANUFACTURES IMPORT VOLUME, 1980-1984

1980 = 100

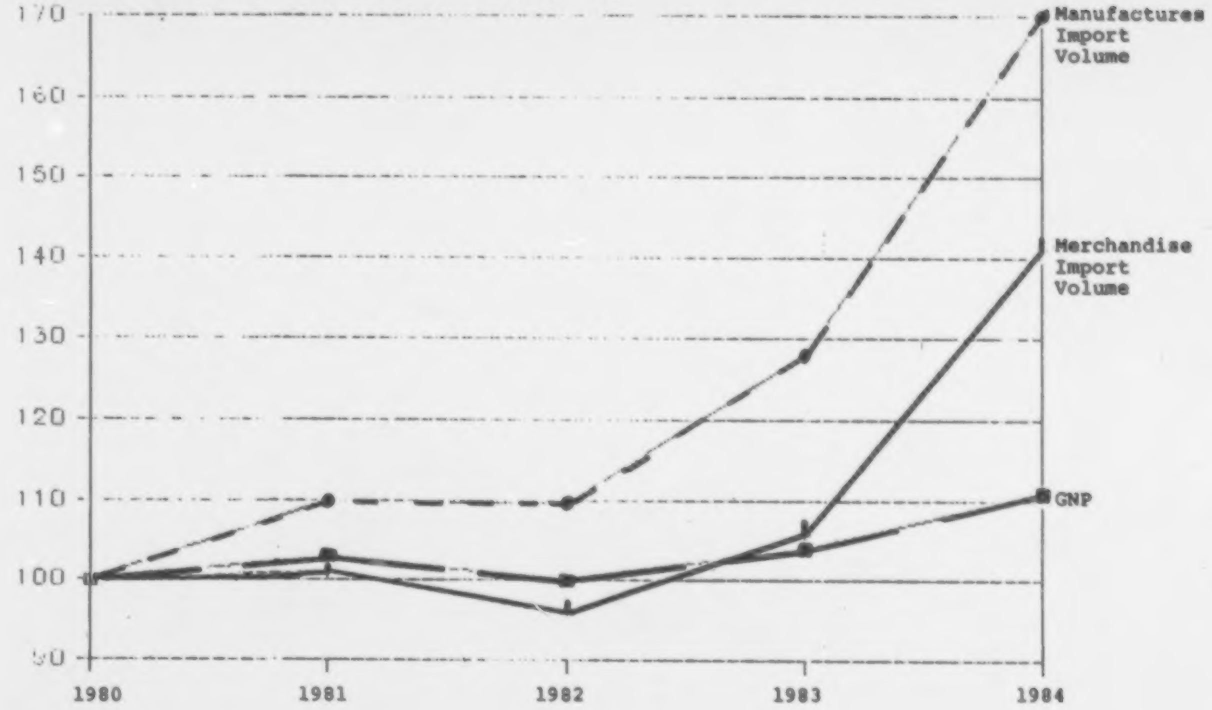


FIGURE 4

REAL CHANGES IN U.S. GNP, MERCHANDISE EXPORT VOLUME, AND MANUFACTURES EXPORT VOLUME, 1980-1984

1980 = 100

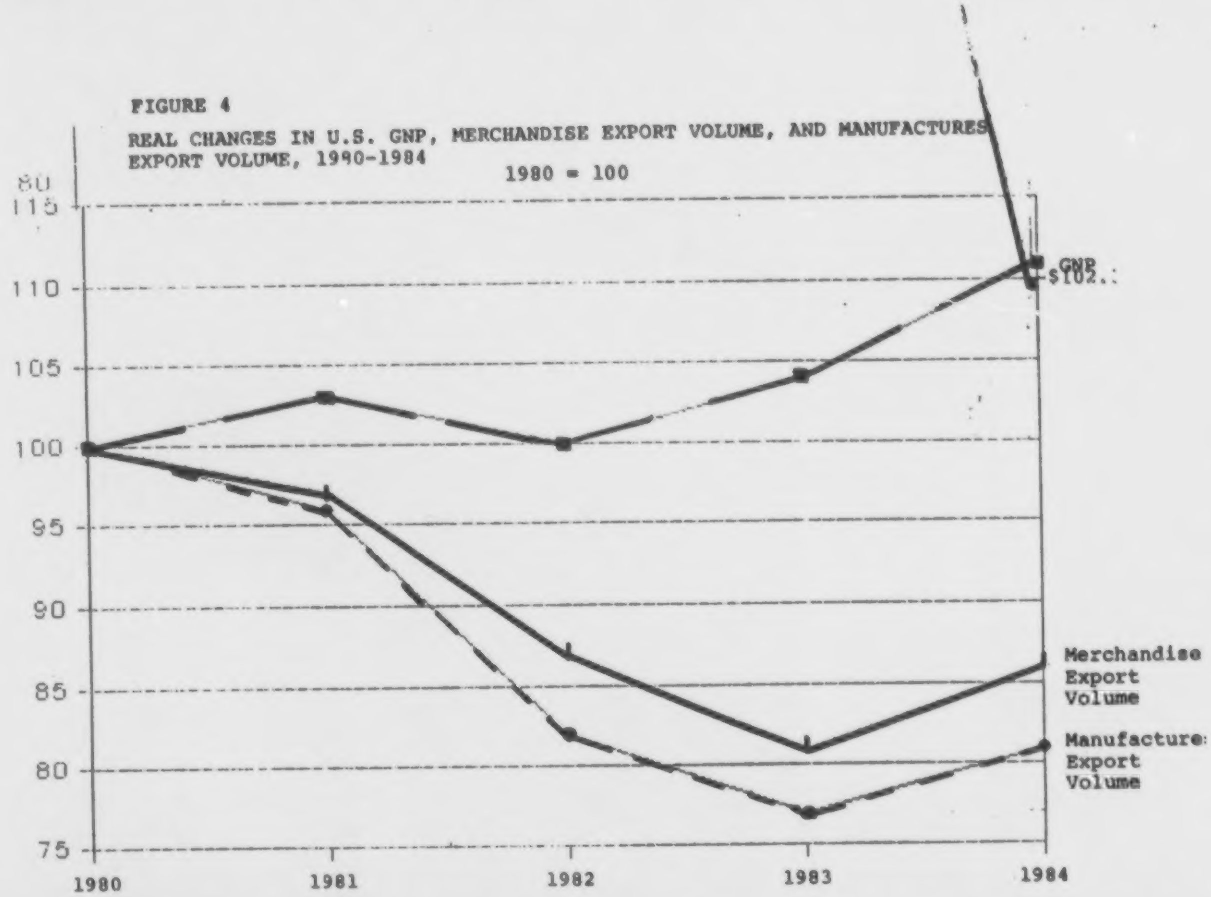
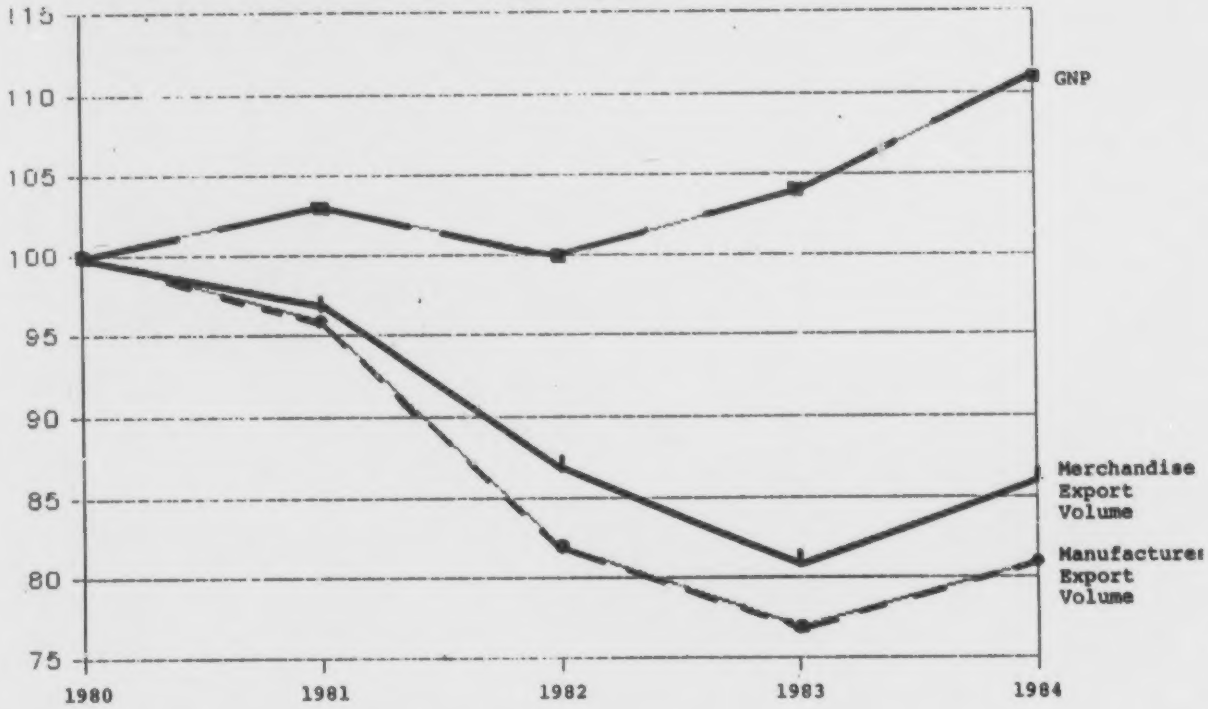


FIGURE 4

REAL CHANGES IN U.S. GNP, MERCHANDISE EXPORT VOLUME, AND MANUFACTURES EXPORT VOLUME, 1980-1984

1980 = 100



economy is booming. By most measures, the United States is in the midst of one of the strongest postwar economic recoveries. Since the end of the recession in 1982 our economic growth has been substantial, with real annual growth of GNP amounting to 3.7 percent in 1983 and 6.8 percent in 1984. The economy shows few signs entering a recession in the near future. Unemployment has been reduced from a high of 10.7 percent at the end of 1982 to 7.2 percent at the end of 1984. Inflation, which stood at 13.5 percent in 1980, has fallen dramatically to about 4 percent, the lowest rate since 1967. With such a strong recovery, it initially does not appear that the trade deficit is hurting us.

Nevertheless, there are causes for potential concern. Our net asset position, the difference between what we have invested overseas and what foreign residents have invested in the United States, is deteriorating. There are questions as to how long we can sustain the trade deficit and the foreign borrowing used to finance it. Moreover, the increase in American imports and our slow export growth are having a substantial impact on those industries that are particularly sensitive to shifting trade flows.

A. Net Asset Position

The increase in our foreign borrowing is reflected in our net asset position. As shown in Table 1, since 1982, our net investment surplus has been shrinking. We increased our total investment overseas, including both official and private assets, by $49.4 billion between 1982 and 1983. Foreigners, on the other hand, purchased an additional $92.9 billion in U.S. stocks, bonds, and other securities during this period. In 1984, capital inflows from abroad exceeded American investment overseas by $95 billion. The United States has been a net creditor to the world since 1917, yet if current trends continue we will be a net debtor before 1985 is out.

The United States is among the world's richest nations. What is wrong with our borrowing extensively overseas? In an economic sense, there is no stigma attached to the current spate of U.S. borrowing. The United States is traditionally a low savings country. Other nations save at a much higher rate and thus have the financial resources available for investment. Where there are willing lenders and a willing borrower, economic theory would say it is appropriate that they do business together.

The real problem is not whether or not the United States is a net creditor or debtor. We have been both in the past. The possible cause for concern rather is our ability to sustain the foreign debt.

There is also the question of whether a capital rich country like the United States should be absorbing as much of the world's financial resources. Shouldn't we be using more of our own money

Table 1 : International Investment Position of the United States
1977-1983
(Billions of Dollars)

	1977	1978	1979	1980	1981	1982	1983	[illegible]
U.S. Assets Abroad	379.1	447.8	510.6	606.9	719.6	838.1	887.5	[illegible]
Foreign Assets in the United States	306.4	371.7	416.1	500.8	576.5	688.6	781.5	[illegible]
U.S. Net Investment Position	72.7	76.1	94.5	106.1	143.1	149.5	106.0	[illegible]

Source: CEA 1985 Report, Table B-102

to fund our investment? In the short-term, the response is that there are few other places for international money to go right now. We have the economy that is expanding; the investment opportunities are here, not elsewhere. Over the longer term, however, it is true that we should finance more of our own investment out of domestic resources.

B. Sustaining Our Foreign Debt

The issue of our being able to support our trade deficit and the concurrent foreign borrowing consists of two points. First, there is the matter of our ability to service the debt we are incurring. In addition, there is a question as to how long foreign lenders are willing to sustain the flow of capital entering our country and funding our trade deficit.

Servicing the Debt: One way to look at the problem is to consider the United States as a private household living on credit. We are using our ability to borrow in order to be able to consume more than we are producing, just as a household makes purchases using credit cards, consumer loans or other forms of time payment. In both cases, standards of living are above those warranted by current earnings. Just as consumer credit has a cost in terms of interest payments and the mortgaging of future earnings to pay for current consumption, we as a nation are incurring a future burden on our living standards through the need to service our debt with remittances, interest and dividend payments to foreign residents.

Continuation of Foreign Capital Inflows: Another potentially worrisome aspect of the huge inflow of foreign capital is that we cannot count on it continuing indefinitely. Even the most creditworthy of borrowers reaches its credit limit. At some point, other countries will no longer be willing to fund U.S. spending. Foreigners need not start to pull their funds out of the United States; they need only reduce the flow of money to us. If they do so, the United States will perforce have to cut back its standard of living.

C. The Effects on Trade Sensitive Industries

Since 1980, American firms have been hit first by recession and now by rising imports at home and slow growth in export opportunities. With the volume of manufactured-goods imports having risen by over 50 percent over the last two years, many have argued that foreign manufacturers, rather than domestic companies, have been the prime beneficiaries of the U.S. recovery. Most of the $231.9 billion in imported manufactured products we purchased last year were directly competitive with American goods. Rather than American firms and workers reaping the benefits of our expansion, it is said that foreign companies are the chief gainers. The argument is made that if fewer imports were entering the United States, our industry would be producing more goods. In turn, increased production would lead to increased employment.

Yet despite the substantial increase in imports, the American manufacturing sector is performing very well. The capacity utilization rate, which measures how much of the productive capability of an industrial sector is in use, is running at its historical average. The average rate for the period 1967-1982 for the manufacturing sector was 81.8 percent. By the end of 1984, our capacity utilization rate was 81.6 percent. Output is up 24 percent from the 1982 low. Accompanying this surge in output has been an drop in the unemployment rate. Unemployment has been cut in half, and total employment increased by about 8 million jobs since December 1982.

These figures indicate that our economy as a whole is operating near or at its peak level. While the economy is running at full steam, however, there are producers, such as textile and steel manufacturers, who have under-utilized capacity. With an expanding economy, an increase in total demand for domestic goods would probably put pressure on prices. Imports are already meeting a significant proportion of our current level of demand. If imports were reduced, that demand would shift back to domestic producers. The economy as a whole might well find it difficult to expand production without upwards pressure on prices.

Not only are imports helping to keep inflation low by filling part of our demand. If one looks at the inflation statistics, prices in traded goods have been relatively flat in the last year. Most of our inflation is accounted for by price increases in the non-traded goods sector and the services sector.

A key issue, therefore, is not the impact the trade imbalance is having on our economy as a whole, but rather its effect on particular sectors of the economy and the jobs in those sectors. The problem is that the effects of the import surge and the rise in the value of the dollar are not being distributed equally over all sectors of our economy. Some sectors have proved more vulnerable to rising imports or slow export growth while others have remained relatively unaffected. Table 2 shows sectors of our economy which are particularly sensitive to shifts in our trade flows. It illustrates the current state of these sectors as compared to manufacturing as a whole in the United States.

On the import side, basic industries already subject to strains because of structural changes in the economy have not experienced a recovery as strong as might have been expected from past experience. The steel industry, for example, continues to suffer from low capacity utilization rates, low output and high unemployment. While it has recovered somewhat from the bottom of the recession, its recovery has not been as strong as might have

TABLE 2

The U.S. Recovery: Changes in Capacity Utilization, Output, Unemployment, Employment, Imports, Exports, and Trade Balance, 1982-1984

Industry (SIC basis)	Capacity Utilization			Output (1967=100)			Unemployment (percent)		Employment			Imports			Exports			Trade Balance	
	1967-1982 avg's	1982 low	1984 IV	1982 IV	1984 IV	% change	11/82	12/84	11/82 (1,000)	12/84 (1,000)	% change	1982 ($ bn)	1984 ($ bn)	% change	1982 ($ bn)	1984 ($ bn)	% change	1982 ($ bn)	1984
Manufacturing	81.8	69.6	81.6	134.5	166.6	24	14.3	7.3	[illegible]	19,735	+6.6	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	-6	[illegible]	[illegible]
Durables	80.5	66.0	82.2	120.0	157.6	31	16.2	7.3	10,496	11,790	+13.2	111.3	175.2	+58	128.0	131.8	-1	+16.7	-53.1
stone, glass, clay	78.4	63.0	78.6	128.0	158.9	25	17.4	8.6	536	605	+10.3	2.6	3.8	+46	1.9	1.9	0	-0.5	-1.9
iron & steel	87.3	38.0	65.5	49.6	73.5	48	28.0	13.3	470	473	+0.9	9.6	16.7	[illegible]	1.9	1.1	-40	-7.9	-7.6
non-ferrous metals	85.8	62.1	81.9	98.3	125.5	28	28.0	13.3	168	157	-4.3	7.0	11.3	+63	3.6	6.1	[illegible]	-3.8	-7.7
fabricated metals	79.6	60.7	77.0	107.3	140.2	31	17.8	10.0	1,394	1,563	+12.2	5.2	8.8	+51	7.7	6.5	-16	+0.5	-0.3
non-elec. machinery	79.8	61.6	80.7	139.7	190.6	36	15.3	5.4	2,067	2,297	+11.1	16.1	27.6	+71	38.9	37.2	-4	+22.8	+9.6
electric machinery	80.0	74.7	93.6	165.9	223.4	35	13.8	6.6	1,870	2,183	+17.0	20.1	35.3	+76	18.3	20.3	+11	-1.8	-15.1
motor vehicles & parts	78.8	46.1	88.1	105.3	169.1	61	°	5.6	[illegible]	[illegible]	[illegible]	30.6	48.3	+58	12.0	15.9	+33	-18.6	-32.4
autos	-	35.8	77.5	81.7	135.0	65	16.0	5.9	315	[illegible]	[illegible]	-			-			-	
aerospace & misc. transportation	79.1	69.1	76.5	86.7	116.7	36	11.5	5.0	1,046	1,070	[illegible]	5.0	5.7	+14	16.7	16.3	-2	+11.7	+10.6
instruments	85.3	73.1	81.1	146.1	170.1	16	10.5	4.6	[illegible]	776	[illegible]	5.4	7.7	+43	8.6	8.7	+4	+3.3	+1.1
Nondurables	83.9	73.8	81.0	155.7	177.6	15	11.5	7.3	7,349	[illegible]	+4.7	56.0	81.9	+46	56.1	53.7	-4	+0.1	-28.2
foods	83.3	78.5	78.7	152.1	160.6	6	10.0	9.3	1,579	1,640	+4.3	9.6	12.8	+33	11.1	11.1	0	+1.5	-0.9
textiles & apparel	86.2	73.0	78.6	123.7	133.1	7						10.6	17.3	+63	3.1	2.6	-16	-7.5	-14.9
textiles	-	-	-	-	-	-	10.6	8.1	731	733	+0.3	2.2	3.5	+59	1.8	1.5	-17	-0.4	-2.0
apparel	-	-	-	-	-	-	14.8	9.7	1,130	1,179	[illegible]	8.4	14.0	+67	1.3	1.1	-15	-7.1	-12.9
paper & products	89.4	86.2	96.6	153.8	173.3	13	8.3	7.0	648	[illegible]	[illegible]	3.3	7.4	[illegible]	6.3	6.3	0	-1.1	-3.1
chemicals & prod.	78.7	64.8	72.2	196.3	229.1	16	7.9	5.8	1,098	1,084	[illegible]	7.6	12.8	+68	20.8	23.6	+13	+13.6	+10.8
petroleum & prod.	88.6	73.3	77.7	120.8	122.6	1	°	-	196	196	[illegible]	10.7	13.3	+25	6.6	5.1	-20	-8.3	-8.1
rubber & plastics	85.3	74.0	93.3	252.1	334.7	33	14.3	5.6	682	[illegible]	[illegible]	3.9	6.4	+62	2.6	2.9	+12	-0.3	-1.5

been expected from previous experience and the highly cyclical nature of the industry. Capacity utilization only recovered to 65.5 percent by the end of 1984, with unemployment still above 13 percent.

In the textile and apparel industry, another sector particularly sensitive to imports, output has risen only 7 percent as compared to a manufacturing average of 24 percent since the recovery began. Employment in the apparel firms has risen a healthy 12.6 percent. On the other hand, textile workers have only seen a small 0.5 percent increase in employment since 1982. Employment has risen despite the fact that imports in each industry are up well above the average for all manufacturing firms. Apparel imports grew 67 percent between 1982 and 1984, and textile imports rose 59 percent. In the apparel sector, the import penetration ratio has risen from about 14 percent to 20 percent.

Our export industries are perhaps feeling the greatest impact from the effects of the trade deficit and its causes, particularly the high dollar exchange rate. While our exports rose 9 percent over 1983, our manufacturing exports remain well under the 1982 level. The United States has traditionally been a strong exporter of such high technology products as aerospace equipment and scientific and professional instruments. Yet in 1984 our exports of aerospace products were 2 percent below the 1982 level, and instruments were only 4 percent higher. Capacity utilization rates in these industries are slightly less than their 1967-1982 averages.

Both the construction machinery and farm machinery and equipment sectors have failed to fully recover from the effects of the recession. In both sectors, the value of shipments has not increased since 1982. Trade shifts account for much of the problem. These are sectors that are dependent on overseas sales. Exports were equal to almost 34 percent of total construction machinery shipment in 1982; the figure for farm machinery was about 22 percent. Construction machinery exports declined over 32 percent between 1982 and 1984 from $4.0 billion to $2.7 billion, while farm equipment exports remained stagnant at about $2.4 billion. In addition, these industries have both been hit with increased imports.

American farmers have been hard-pressed in the face of declines in agricultural exports. Our shipments of farm products overseas, which peaked at just over $44 billion in 1981, fell to $36.5 billion in 1983 and recovered only modestly to $38.2 billion last year. Current forecasts are that our agricultural exports this year will drop to $34.5 billion, the lowest level since 1978. Imports, on the other hand, rose 20 percent between 1983 and 1984, from $18.0 to $21.6 billion. The loss of farm income from overseas sales is having a direct impact not only on our farmers but also on those industries dependent on farmers, such as firms producing farm equipment.

The loss of export markets and the rise in U.S. imports, if prolonged, could begin to affect the structure of our industry in a significant fashion. The longer American companies are kept out of foreign markets, the greater the difficulties they could face in trying to recapture those markets as our exports become more competitive. Similarly, the longer Americans are accustomed to buying foreign goods, the more trouble our companies may have trying to sell products here at home. Relationships are established between buyer and seller that could be hard for our firms to break into when they can reenter the market.

Moreover, the growing imbalance in our trade and its effects on particular sectors are stoking the fires of protectionism. As our imports rise and our exporters face difficulties in selling overseas, some people are turning away from our traditional policy in favor of free and fair trade and suggesting we should restrict our own imports. For example, an import surcharge has been proposed as one way of reducing both our trade and budget deficits.

D. Other Effects of the Trade Deficit

The trade deficit and its underlying causes are having other effects, both within the United States and internationally.

The counterpart to our trade deficit is the flow of foreign funds into the United States. These funds represent money that is available for investment by our own industry. Our companies are using this money to modernize their plant and equipment, thereby promoting increases in U.S. productivity and competitiveness. For example, in 1974, Japanese factories were on average one-third newer than American plants. By 1983, the average age of our factories was 5.4 years as compared to 5.7 years in Japan. Such investment helps preserve American jobs. The foreign funds entering the United States are making investments by domestic companies possible that might otherwise not occur because we do not save enough.

In the absence of foreign capital flows into the United States, it is likely that interest rates would be higher than they are today. As a nation we have not saved enough to fund the current level of investment. With domestic capital relatively scarce, companies that want to make investments would bid up the price of capital if foreign money were not entering the United States. Without the foreign capital inflows, our interest rates would almost certainly rise substantially.

Foreign capital is also entering the country in the form of foreign direct investment. In this case, rather than making funds available for our businessmen to invest, foreign investors establish their own plants or make direct purchases of existing companies in the United States. During the first three quarters of 1983, foreign direct investment in the United States totalled over $15.5 billion, $4 billion more than was directly invested in all of 1983. The benefits of this type of investment include access to foreign technology and managerial skills.

Our trade deficit is assisting our overseas neighbors. Imports sold in the United States are the mechanism by which our recovery is transmitted to our trading partners in both the developed and developing world. One estimate by Salomon Brothers is that 9.4 percent of Britain's growth, 15.2 percent of Japan's, 16.7 percent of Germany's and 33 percent of growth in Canada in 1984 was due to increases in their exports to the United States. Much of the growth in Latin America last year may be accounted for by their increased exports to us. By fostering their economic growth through increased imports, we not only help them but we help ourselves. As their economies improve, so does their propensity to buy goods from the United States.

Not only is our trade deficit promoting economic expansion in the developing countries; it has the additional benefit of easing the burden of high-debt developing nations. Most of the borrowings by the high-debt countries are denominated in terms of dollars and must be repaid in dollars. The United States, by taking more of these countries' exports, is transferring the financial resources these countries need to service their debt. In addition, since many of the loans to the debtor countries originated with American banks, the trade deficit is indirectly assisting them in reducing their amount of questionable loan balances.

The positive effects for our trading partners resulting from our trade deficit are short-term benefits. In the longer scheme of things, it would be inappropriate for the United States to continue to boost world economic growth as much as we have over the past two years. The United States would increasingly be a crutch on which the world could lean, rather than providing a temporary shot-in-the-arm for world recovery.

As we bring our own economy more into balance by reducing our trade and budget deficits, more growth will have to be generated by the rest of the world. Room will be created for other developed countries to take stimulative measures to expand their economies.

For developing countries dealing with debt problems, an easing of their debt burden should allow those countries to gradually shift from restrictive to expansionary policies. With their debt more in line with their ability to service it, their access to foreign private capital should be restored. In turn, these nations should be able to shift their external trade accounts from substantial surplus to more balanced positions.

Having considered some of the potential problems caused by our trade deficit, we need to consider how to deal with those concerns. Before doing so, however, it is important that we understand what is causing the deficit. The problems created by the trade deficit are only symptoms, not causes. If we are to treat the problems in a meaningful fashion, we have to deal with the causes of our trade deficit.

Causes of the Trade Deficit

The causes of our trade deficit have been much debated. Many critics of U.S. trade policy charge that we have not been tough enough in our efforts to open overseas markets to American products. As noted below, however, these barriers play are not a major problem.

More reasoned analysis reveals that the bulk of our trade imbalance results from three macroeconomic factors:

- the debt crisis in developing countries,
- the difference in economic growth rates among the United States, Europe and Japan,
- and the substantial foreign capital inflows that are pushing up the value of the dollar.

A. Developing Countries and the Debt Crisis

One cause for our poor trade performance is the result of developing country efforts to restrict their imports and boost their exports because of their debt problems. The debt crisis has had a direct impact on the trade balance of the United States. In attempting to earn and conserve needed foreign exchange, high-debt developing nations have boosted their exports, restricted imports and lowered total domestic consumption. The result has been a significant negative shift in our trade balance with these countries.

The debt crisis has hit the United States, and to a lesser degree all industrial countries, because developing countries have become key players in international trade. Between 1970 and 1980, the average growth rate of developing country exports (excluding oil-exporting developing nations) was 8.8 percent as compared to 5.8 percent for the industrial world. North-South trade grew faster than any other area of trade. Total trade between developed and developing countries amounted to $541 billion in 1983.

Fuelling the growth of North-South trade has been a huge increase in borrowing by developing countries. Developing country debt increased five-fold between 1973 and 1984, from $130.1 billion to $812.4 billion. Major debtor nations today include Brazil, Mexico, Argentina, Korea and Venezuela.

While both public and private lending to developing nations has risen substantially, the growth of private lending has been half again as large as the growth of public lending. While official lending rose by 241 percent over the 1974-1983 period, private lending soared upwards by 385 percent.

Following the announcement in 1982 by Mexico that it could not pay its debts, international banks reduced their lending not only to Mexico but also to other debtor nations. Their access to credit restricted, the high-debt developing countries could no longer finance their current account deficits through borrowing.

Unable to borrow, these countries were forced into a "pay-as-you-go" policy in which current foreign exchange earnings, and not foreign loans, had to finance current consumption. The actions resulting from this policy were threefold. First, the nations had to reduce current consumption. By lowering domestic demand, they reduced their level of imports.

Lower domestic demand by itself, however, did not result in a sufficient drop in imports in many debtor countries. They therefore enacted policies to actively discourage or restrict imports. Mexico, for example, reversed a late 1970s trend towards import liberalization and instituted a strict import licensing procedure. Brazil imposed an import ceiling on many of its companies and cut the level of imports be state-owned companies drastically. U.S exports to Brazil dropped 30 percent between 1981 and 1984.

While limiting imports saved these countries foreign exchange, it did not actually earn them additional hard currency. The final step in their retrenchment efforts included a strong push to increase their exports. Brazil's exports to the United States jumped upwards by two-thirds between 1981 and 1984, and both Mexico and Chile increased their exports by over 29 percent.

As shown in Table 3, the impact of these policies was particularly severe on the United States. Many of the largest debtor countries are located in Latin America, where strong trade and financial links exist with the United States, and where the United States has tended to run trade surpluses.

In 1981, the United States had a $5.0 billion trade surplus with 6 high-debt Latin America countries: Argentina, Brazil, Chile, Mexico, Peru and Venezuela. Between 1981 and 1984, however, as those countries cut back on imports and boosted their

Table 3: U.S. Trade Balance with Selected High-Debt Latin American Countries, 1981 and 1984
(Millions of Dollars)

	1981 U.S. Exports	1981 U.S. Imports	1981 Balance	1984 U.S. Exports	1984 U.S. Imports	1984 Balance	1981-1984 Change
Argentina	$2,128.0	$1,123.3	$1,004.7	$869.5	$929.3	-$59.7	-$1,064.4
Brazil	3,742.0	4,332.6	-590.6	2,585.2	7,208.0	-4,622.8	-4,032.2
Chile	1,436.3	543.3	893.0	793.0	701.4	91.6	-801.4
Mexico	17,353.1	13,703.6	3,649.4	11,461.2	17,762.4	-6,301.2	-9,950.6
Peru	1,466.9	1,146.6	320.3	738.1	1,264.7	-526.6	-846.9
Venezuela	5,346.8	5,575.3	-228.5	3,307.1	6,474.9	-3,167.9	-2,939.4
TOTAL	31,473.1	26,424.7	5,048.3	19,754.1	34,340.7	-14,586.6	-19,634.9

Source: USTR

exports, our trade position shifted sharply into a deficit. These six countries reduced their imports from the United States from a total of $31.5 billion in 1981 to $19.8 billion, a 37 percent decrease. Moreover, their exports to us rose by 30 percent from $26.4 billion to $34.3 billion.

As a result, in 1984, the United States ran a $14.6 billion trade deficit with these six countries. The net swing of $19.6 billion in three years shows how the shift has contributed to our trade deficit. For January and February of this year, our trade situation with these countries is slightly better than at the same time last year. Our trade deficit with these countries is about $450 million lower than a year ago.

B. U.S. Economic Growth

Another factor contributing to the deterioration in the trade deficit is the earlier and more robust economic recovery in the United States as compared to our trading partners. By historical standards, the current recovery has been extremely strong in America. From the end of 1982 to the end of 1984, real gross national product (GNP) increased at an average annual rate of 5.3 percent. This increase is significantly greater than the average rate of five previous post-war recoveries.

With a booming economy, the United States has taken in increasing imports, while export growth has lagged behind. As noted earlier, imports are up by 26 percent over 1983, while exports have grown only 9 percent. This gap is to be expected. As the economic leader, the United States has traditionally acted as the engine pulling other countries along in the wake of its economic expansion. America's demand for other countries' products is the means by which economic expansion in the United States is transmitted to our trading partners.

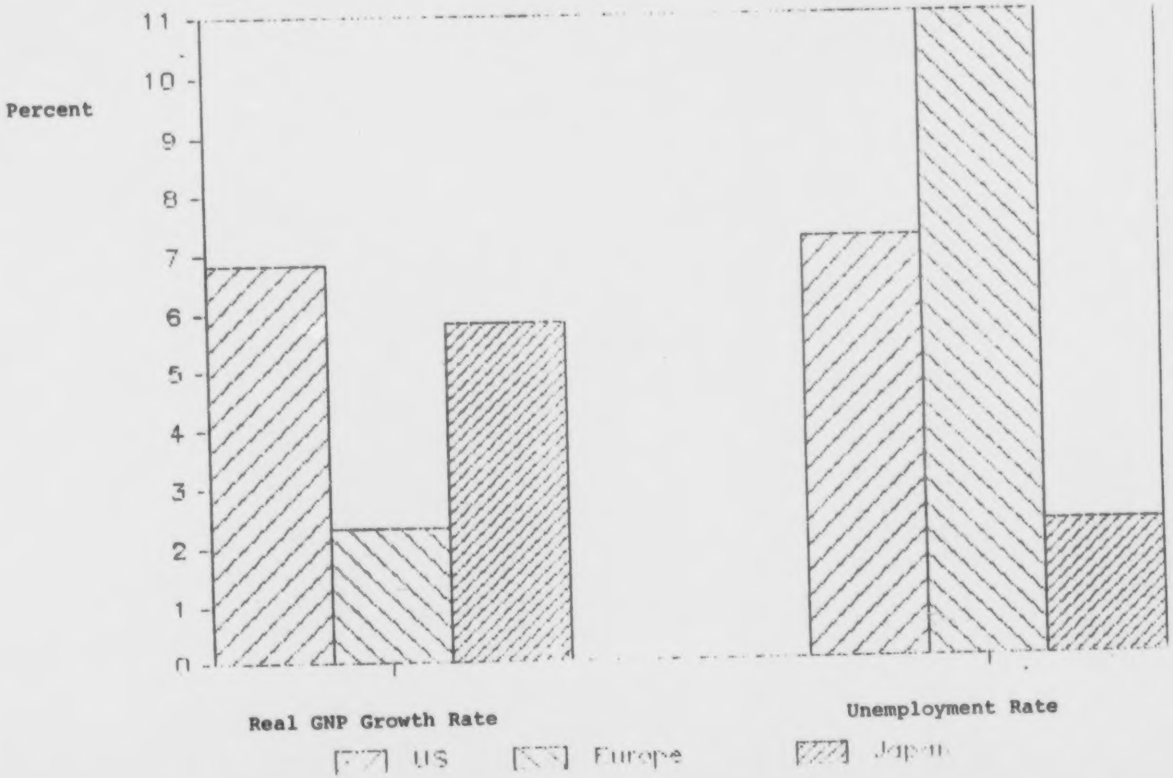
In contrast to earlier recoveries, however, strong U.S. growth at best is being transmitted slowly to other countries. Despite the fact that the growth of U.S. imports has been more than double the rate of growth during the 1975-76 recovery, increased trade has so far been unable to provide the driving force for export-led recovery in other countries. What our trade deficit has done is to keep those countries from sliding into even worse economic conditions.

Particularly in Europe, economic growth has been anemic, and the prospects for future expansion are rather weak. (See Figure 5) For 1984, European growth was only 2.3 percent and in Japan it was 5.8 percent as compared to 6.8 percent in the United States. Unemployment has remained much higher in Europe than in America: 11.0 percent in the former and 7.2 percent in the latter. The outlook for European expansion in the near term is projected to be between 2-3 percent for 1985 with a falloff to

FIGURE 5

GROWTH IN GNP AND UNEMPLOYMENT RATES IN

The US, Europe, and Japan in 1984



1-2 percent in 1986.

Economic expansion in the United States coupled with slow growth elsewhere has contributed to our trade deficit in two ways, one of which is the direct trade impact of the recovery. As our economy grows and personal income rises, people have a tendency to spend a larger share of their earnings on imported goods. If Europe was experiencing the same type of expansion as we are, it, too, would be increasing its imports. The problem is that many of our trading partners are not at the same point in the cycle of the recovery as we are; the differential in our growth rates is making a substantial contribution to our trade deficit.

While it is difficult to be precise, it is possible to derive a rough measure of how much the difference in growth rates between the United States and Europe and Japan is adding to the trade deficit. Countries all have a certain propensity to consume imported products, a tendency which increases as incomes rise. If Europe and Japan had grown at rates similar to the expansion experienced by the United States, our trade deficit with those countries would have been about $15-$20 billion smaller than it actually was.

C. Foreign Capital Flows

Economic Expansion in the U.S.: The difference between our growth rate and those of our trading partners not only affects trade flows but capital flows as well. Foreign capital enters the United States for many reasons. We are seen as a safe, stable haven for investment funds. Interest rates have been higher in the United States than in other countries.

In addition, with our economy booming and those of our allies languishing, we have investment opportunities that do not now exist overseas. In 1984, gross private domestic investment in the United States was $637.3 billion dollars, 35 percent higher than in 1983.

Investment in this recovery is substantially above that of previous economic recoveries. (See Table 4) Gross private domestic investment was 17.6 percent of GDP in 1984, as compared to an average for the six previous recoveries of 16.3 percent. The difference of 1.3 percent means that our investment requirements were $47 billion more than if we were in an "average" recovery.

While private investment has surged during the current period of economic expansion, its recovery in and of itself need not have led to the increase in foreign capital inflows that has occurred since the end of 1982. We could have provided domestic financial resources to finance our investment. The difficulty is

Table 4: Saving and Investment in the United States During the Second Year of Recovery, 1951-1984

Period of Recovery	Gross Saving	Gross Private Domestic Investment	Gross Domestic Product	Savings Share of GDP	Investment Share of GDP
	(Billions of dollars)			(Percent)	
1951(II)-1952(I)	$56.4	$57.5	$333.9	16.9%	17.2%
1955(III)-1956(II)	72.5	70.8	408.8	17.7	17.3
1959(III)-1960(II)	81.0	79.3	495.8	16.3	16.0
1962(II)-1963(I)	87.4	85.8	567.2	15.4	15.1
1972(I)-1972(IV)	186.6	195.0	1175.0	15.9	16.6
1976(II)-1977(I)	263.5	270.4	1740.5	15.1	15.5
			Average of above:	16.2	16.3
1984(I)-1984(IV)	551.0	637.3	3616.3	15.2	17.6

Source: USTR

that domestic funds were not available.

The Savings Shortfall: At the heart of the problem of the foreign capital inflows and our trade deficit is our failure to save enough to meet the investment needs of a rapidly expanding economy at a time of record budget deficits. Box 1 shows the relationship between the influx of foreign funds and the trade deficit; it also illustrates the link between domestic savings and investment and net foreign investment.

In brief, where the level of gross domestic saving is insufficient to meet private investment demands, foreign funds make up the shortfall. Private investment in 1984 was $637.3 billion. Gross domestic saving came to $551.0 billion. The difference was accounted for by net foreign capital less a statistical discrepancy.

This gap between domestic saving and domestic investment is not typical of previous economic recoveries. During the second year of previous postwar recoveries, domestic saving on average slightly exceeded domestic investment and was never more than 0.7 percent of GDP less than domestic investment. In 1984, that gap was 2.4 percent. The change is accounted for by two factors. The first, as discussed above, is that investment in the current recovery is substantially higher than in previous recoveries, even those of the early 1950s, a period of exceptionally high investment.

As important, however, is the fact that total domestic saving is lower than the average of the earlier recoveries. Gross saving in the United States averaged 16.2 percent of GDP during the previous recoveries. Last year, our gross saving came to 15.2 percent of GDP. Only the recovery in 1976-1977 had a lower figure.

It is critical that we understand what is causing domestic saving to be so low. Domestic saving is made up of the private savings of individuals and corporations plus the savings (or borrowings) of government. With respect to private saving, saving by business came to $518.4 billion in 1984, up almost $65 billion from 1983. Business saving as a share of GDP in 1984 was well above its historical average. Tax cuts have raised the after-tax profits of corporations, which in turn have raised their level of saving and investment. Saving by individuals increased about $39 billion between 1983 and 1984, totaling $156.9 billion in that year. Unlike business saving, however, household saving is not above its historical average. Indeed, it is at the lower end of the scale.

Nevertheless, total domestic private saving, at $675.3 billion, would have been more than enough to meet our investment needs in 1984 if Federal government had not been such a large

Box 1

THE RELATIONSHIP BETWEEN THE FOREIGN BALANCE AND DOMESTIC INVESTMENT

In balance of payments accounting, the balance on trade in goods plus the balance on services, interest and transfers is equal to net foreign investment, as set out in the following equation:

Foreign Balance   Domestic Saving and Investment

T + S = NFI = PS - GB - PI + SD

T - Balance on trade in goods
S - Balance in services, interest and transfers
NFI - Net foreign investment
PS - Gross private saving, made up of corporate saving plus household saving
GB - Net government borrowing, consisting of the budgets balances of the Federal government and state and local governments
PI - Gross private domestic investment
SD - Statistical discrepancy

As the deficit on trade in goods and services increases, so does the level of funds foreigners must invest in the United States. Similarly, for each dollar being purchased by foreigners and invested in the United States, Americans have to buy a corresponding amount of foreign products. The flow of foreign money into the United States is financing our trade deficit. While boosting the dollar's exchange rate, this influx of funds in a real sense has been allowing the United States to import more goods and services than it exports. At the cost of a rapid accumulation of foreign debt and large trade deficits, we have been able to increase our standard of living at a faster rate than that warranted by the growth of the American economy.

The right-hand side of the equation shows the link between domestic savings and investment and net foreign investment. Where the level of private savings combined with net government borrowing (or net government surplus) is insufficient to meet private investment demands, foreign funds will make up the shortfall.

The figures for 1984 (billions of dollars) are as follows:

T + S = NFI = PS - GB - PI + SD

-107.6 + 13.1 = -94.5 = 675.3 - 124.4 - 637.3 + (-8.2) borrower. The surpluses being run by state and local governments were countered by the Federal budget deficit. The historical pattern of post-war government spending is that in a recession the Federal government runs a counter-cyclical budget deficit in order to stimulate the economy. As economic expansion takes hold, government spending normally falls back into line with revenues and so the government basically runs a balanced budget.

In the current recovery, however, the Federal government continues to run substantial budget deficits. The Federal budget deficit in 1984 was $176.4 billion. Against this deficit was a surplus at the state and local level of $52.0 billion. The result was that net government borrowing was $124.4 billion, a substantial drain on our pool of national saving. Domestic private saving was simply insufficient to finance both exceptional Federal deficits and a big investment boom. Although private savings exceed private investment, the Federal budget deficits are more than absorbing this cushion.

Capital Flows and the Exchange Rate: The shortfall in domestic saving is being filled by a net inflow of $95 billion of foreign capital. The net capital flow is the difference between total foreign capital outflows from the United States and total capital coming into America from abroad adjusted by a sometimes substantial statistical discrepancy. In 1984, for example, the statistical discrepancy was $30 billion.

The more significant shift in capital flows was the drying up of capital leaving the United States for investment overseas. Gross capital outflows from the United States dropped by more than $28 billion last year, from $49.4 billion in 1983 to $21.2 billion in 1984.

At the same time, there was an increase in the amount of money entering the United States from other countries. These capital inflows rose by $11.1 billion, from $81.7 to $92.8 between 1983 and 1984. Three major categories accounted for the bulk of U.S. borrowing in 1984: 23 percent was in the form of private direct investment from abroad, 38 percent was made up of purchases of Treasury and other U.S. securities by private foreign investors, and 30 percent was an increase in the liabilities of U.S. banks to, for the most part, non-affiliated foreigners.

The dollar's exchange rate has been swept up on this tide of foreign borrowing as foreign residents exchange their home currencies for dollars to lend and invest in America. The rise in the dollar in turn contributes substantially to the trade deficit. Underlying that rise, however, is a national failure to save enough to finance our investment needs and our reliance on foreign credit to finance strong economic growth.

All things being equal, our trade deficit should cause the dollar's exchange rate to drop. The United States, by increasing its imports so dramatically, is flooding the world with dollars. Under a flexible exchange rate system, the rate of exchange of the dollar should reflect the international supply and demand for dollars; an increase in the supply of dollars available abroad should cause a drop in the price (exchange rate) of the dollar as the demand for dollars is filled. A depreciation of the dollar would cause the price of imports into the U.S. to rise over time and the price of American exports to fall, thereby helping to correct the deficit.

As a result of current macroeconomic conditions here and abroad, however, there is little indication that the world's demand for dollars is being filled. Our rising demand for foreign credit has boosted foreign demand for dollars. As a result, our exchange rate rises as the price of dollars is bid up. The exchange rate is the mechanism by which the inflow of foreign capital is equated to the flow of real resources, in terms of goods and services, that are being transferred on the trade side.

As foreign capital flows into the United States, a demand is created for dollars and the exchange rate is set. As more foreign capital enters the United States, the continuing demand for dollars pushes the exchange rate higher. In turn, as the exchange rate rises, the price of imports into the United States falls and our export prices rise. As a result, we start to import more goods and services while in comparison our exports perform poorly. As long as we continue to be a large net importer of foreign capital, we will almost certainly run substantial trade deficits. In 1984, for example, we ran a current account deficit of over $100 billion, which was fed and financed by our net borrowing from abroad.

D. Foreign Trade Barriers

It is natural for people to think that our trade deficit is the result of trade barriers by other countries. If these foreign trade restrictions were removed, it is said, we would not have the trade imbalance that exists today.

While it is true that our trade deficit might be smaller if other countries removed all their barriers to our exports, the foregoing analysis reveals that foreign trade restrictions are not our main concern. We must remind ourselves that these barriers are not the chief cause of our trade problems. Our trade deficit has only worsened significantly over the past two and a half years, yet many of these trade restrictions have been in force for much longer. Moreover, we have introduced our own trade restrictions in such areas as steel, actions which have served to limit our imports.

In an ideal, free-market world there would be no restrictions on U.S. exports. Yet in the highly unlikely case that other countries removed all their barriers to U.S. products, and we were allowed to keep the restrictions we now impose on foreign goods, our trade balance would only improve marginally. To paraphrase Shakespeare, the fault is not in our stars (or with our trading partners) but rather is in ourselves.

What Is To Be Done

While granting that foreign trade barriers are the key problem, it is nevertheless imperative that we work to reduce such barriers where they exist. Market access for our exporters in such areas of agricultural products and manufactured goods must be vigorously pursued.

We in the United States have managed to keep our markets open despite our worsening trade balance. Nevertheless, the trade deficit is causing a serious erosion of public support for policies designed to promote trade liberalization. As imports have entered the United States in increasing quantities, and as our exporters have been shut out of overseas markets, there have been calls for increased protectionism here.

Suggestions have been made that in order to reduce our trade and budget deficits we should impose a temporary import surcharge. In the short-term such action might serve its stated purpose: Federal revenues would rise and imports would probably decline. However, an import surcharge, or any tariff increase for that matter, is unwarranted, undesirable and short-sighted.

Any increase in the general tariff level of the United States has an anti-trade bias that would tend to cause the dollar to appreciate even further, thereby causing more damage to our exporting industries. In addition, a tariff rise would probably lead to retaliation by our trading partners and so move the world in the direction of trade restriction at a time when trade liberalization is what is needed.

There are no easy, short-term fixes for the imbalance in U.S. trade. What is needed are policies that will reduce the Federal budget deficit, boost domestic saving, promote a gradual decline in the value of the dollar and provide a solid basis for growth in the United States and our trading partners. Actions taken to reduce the trade deficit will take time to be felt.

Given the relationship between our trade deficit, foreign capital inflows, and the rate of domestic saving and investment, steps must be taken to increase saving in America. As long as we continue to spend and invest more than we save, we will have large foreign capital inflows and run a substantial current account deficit.

Accordingly, if we are to take meaningful action to reduce the trade deficit, we must cut the Federal budget deficit and boost the rate of private saving. We need a tax reform package that encourages our households to save and invest rather than to borrow and consume on credit. If we can narrow the gap between our domestic saving and investment by increasing the level of saving and limiting government borrowing, our interest rates should begin to fall. The flow of foreign capital into the country should diminish as a result, leading to a reduction in the value of the dollar and an improving trade balance.

Such a domestic program needs concomitant international steps. The problems of developing country debt and slow growth overseas are not one the United States can solve on its own. The key is the initiation of new multilateral trade negotiations. Economic rigidities and trade-distorting policies are contributing to the problems faced by Europe and many developing countries. A more free and open trading system would help to reduce these hindrances to growth.

Among our goals for a new round of trade negotiations is the strengthening of the international trading system to ensure that trade is both free and fair. The GATT rules on safeguards and dispute settlement need to be changed so that they are both more fair and more effective. Trade in services needs to be brought under the GATT, with rules limiting the introduction of new barriers affecting this sector and setting out a basis for the reduction of existing barriers. Similarly, in high technology products, measures affecting U.S. exports must be reduced, including restrictive government procurement practices and standards, inadequate intellectual property rights protection, and high tariffs on electronic parts and equipment. Rules of the game must be set for the use of agricultural subsidies. Finally, we should work towards the reduction of barriers to international investment.

None of these tasks - reducing the budget deficit, increasing our savings rate, and new multilateral trade negotiations - will be quick or easy to achieve. But if we are to reduce our trade deficit, they are the steps that must be taken.

Chairman **LaFalce**. Mr. Carper.

Mr. **Carper**. Thank you, Mr. Chairman. It is a real privilege for me to have an opportunity to introduce not a constituent of mine in the State of Delaware, but someone who certainly serves for a major corporate constituent, the Du Pont Corp. Dick Heckert is a resident of a neighboring town in Pennsylvania. He has worked for the Du Pont Co., I think, since the age of 17——

Chairman **LaFalce**. I'm not sure we would have invited him, Tom. I thought he was from Delaware. [Laughter.]

Mr. **Carper**. He joined the Du Pont Co., I think, as a research chemist in 1949. And he's been with the company since that time in a number of capacities—research and development, manufacturing and management.

He is now vice chairman of the board at the Du Pont Co. My understanding is that we have two vice chairs, one, Mr. Bailey, heads up the Conoco operation, and Mr. Heckert, who heads up the Du Pont board.

I think we are fortunate to have him today. I again applaud the subcommittee's decision to invite him to be one of our witnesses. He is also a member by Présidential appointment of the Advisory Council for Trade Negotiations. And with his vast experience in this area and the position of Du Pont Co. as a world corporation, it should be very helpful in our deliberations.

I welcome you. Thank you for joining us.

Mr. **Heckert**. Thank you, Mr. Carper for the kind words. I'll proceed.

STATEMENT OF RICHARD E. HECKERT, VICE CHAIRMAN, E.I. DU PONT DE NEMOURS & CO.

Mr. **Heckert**. Mr. Chairman, I took you seriously. While the first speaker was giving his address, I eliminated several paragraphs from my speech. I hope it still hangs together.

The point I want to make today is that our Nation's economic and trade policies must be adjusted to support rather than to detract from industrial competitiveness. The country's well-being and the future of international trade depend on it.

The Government profoundly affects the ability of industry to compete in both domestic and overseas markets, but in developing economic policy, our Government has given low priority to industry's needs. As a result, our industrial infrastructure is being hurt badly.

It's not just a few old line industries that are in trouble, but all of the key industrial sectors, including the so-called high technology fields plus agriculture. For all their many strengths, the goods producing industries in this country are less able to compete in world markets today than at any time since the end of World War II. It would be foolish to let this situation continue and it is also unnecessary because we have the power to change it.

Let me expand briefly on those points. The most important single problem for us in the past few years has been the rise in the exchange value of the dollar versus other major currencies. And that is largely a reflection of the high real interest rates and the growing Federal deficits.

In less than 5 years, the dollar has gone up by more than 50 percent relative to the composite index of other currencies. What that means is that products being imported into the United States arrive here with a large price advantage—in effect, a subsidy—while the U.S. products we try to sell abroad carry a large penalty.

Another factor is U.S. trade policy. Our Government has consistently pressed for free trade arrangements, but most other nations do not run free trade economies. Instead, they use subsidies, quotas, government procurement practices, domestic content rules, targeting practices, and other tariff and nontariff barriers to give their own producers the advantage.

Everyone is familiar with the problems of steel, but that is only the tip of the iceberg. Most other industries are involved, too, including the so-called technology intensive ones. That group of industries had a $27 billion trade surplus in 1980. Last year, that number had shrunk to $5 billion.

The U.S. chemical industry has been a world leader for many years and has routinely been a large contributor to a favorable balance of trade. However, many of our export businesses are now unprofitable and the trade surpluses that we generated prior to 1980 have been cut by one-third.

It's clear that we in the private sector have to do everything that we can to make ourselves more competitive. This calls for more and better research and development, aggressive capital spending, better marketing, and better use of people throughout our operation. We're working hard on those points; however, by ourselves, we cannot close the gap that has been created by the runup in the value of the dollar. A few specific examples.

My company makes Mylar polyester film in South Carolina and in Ohio. We also have a subsidiary company making the same product in Luxembourg. The plants are fully modern, comparable in efficiency. Yet, when the costs are translated into dollars at current exchange rates, we find that it costs 20 to 25 percent less to make Mylar in Europe than here at home. We can import Mylar from Europe, pay the freight and the duty, and sell it profitably at a lower price than our domestic product.

Teflon fluoropolymer resin is another Du Pont example. We can import it from our plant in The Netherlands with a 202-percent cost advantage over the Teflon that we make in West Virginia. We make a plastic called Delrin or acetal resin. The cost difference between Europe and the United States is 40 percent. And, again, the plants here and there are almost identical twins. There is no way we can offset such large cost differences by squeezing the production process harder here in the United States.

We can bring in new technology, of course, and we do. That's being done by most companies. But, remember, the same new technology can be utilized in our plants overseas; the water level goes down in both tubs.

The textile industry is taking an especially tough beating. Many people view textiles as an old-line, labor-intensive, unsophisticated industry. The fact is that the leading textilemakers have spent hundreds of millions of dollars putting new technology into their U.S. plants. Yet, that industry is literally being taken apart by imports.

Those imports have grown so fast that, today, nearly one-half of the apparel sold in the United States comes from abroad. The impact on employment is severe. The textile industry employees, many women, blacks, and Hispanic. Many of its workers are in the lower end of the economic scale, where unemployment generally causes the greatest personal hardship. About a half-million jobs have been lost in the U.S. textile industry in recent years.

On an all industry basis, the strong U.S. dollar and related problems have cost the country an estimated 2 million jobs. And that number will certainly grow unless something is done about it.

Fortunately, a great deal can be done. As I said, our biggest problem is the exchange value of the dollar. If Government can reduce its budget deficits, rationalize fiscal and monetary policies, that would help bring down real interest rates, and then the dollar should move downward toward purchasing power parity.

Of all the steps that might be taken to improve America's competitiveness, I think this one is first in importance. If the dollar came down, I firmly believe that the majority of our international trade disadvantages would go away.

Second, tax and regulatory policies have to be reexamined against the realities of international economic competition. The tax system as presently designed is anything but neutral with respect to trade. For the most part, other nations encourage savings and investment. We focus taxes on income. Other countries apply more of the burden to domestic consumption, through national sales or value-added taxes, which are excused on their exports. That makes their exports more competitive in foreign countries.

It is common in other countries for industry to write off costs for new plant and equipment in a year or two. In the United States, the depreciation allowances stretch out over much longer periods of time. Point by point, our companies are placed at a disadvantage versus foreign competitors. As a practical fact, we do not have a protrade policy in this country, we have a proimports, antiexports policy.

To compound the problem, we have burdened ourselves with real interest rates that are far above historic levels, which makes our cost of capital still higher. Furthermore, many U.S. plants have to compete with foreign plants built with outright capital grants from Government. We have to play the game with our own money. Some of our international competitors play with one hand in their Federal till, quite an advantage.

As a third point, I believe the United States should be tougher in its trading stance with other countries. We should send a strong signal to them that we are going to do whatever is necessary to bring our imports and exports more nearly into balance. At a bare minimum, we should insist that if others wish to continue to have access to the U.S. marketplace, the companies located here in the United States must have comparable trade and investment opportunities in the markets outside the United States.

In recent months, there has been much talk about reducing trade barriers in other countries, and notably Japan. In our industry, visible barriers are not the problem in Japan. The Japanese have an excellent understanding of what is good for them. They readily buy from us those things not available at home, and strongly favor their own suppliers for everything else.

That strong sense of the national good is lacking here in the United States. Above all, we should quit apologizing for acting in our own Nation's long-term self-interest. That is no different from what other governments have been doing all along.

Our friends abroad argue that we cannot close our markets to them because they must export to survive. For some countries, that may be true. The United States is more fortunate; we do not have to export in order to survive. We only have to export in order to cover the cost of our imports. Other countries can claim no inalienable right to our marketplace and deny us theirs.

I hear it said that the United States cannot take aggressive action because other countries will retaliate and then we'll have an all-out trade war. I don't buy that. Other countries have at least as much to lose by such a confrontation as the United States has, and they know it.

It is also said that there really is no serious problem, but only a matter of making some minor adjustments in our industry mix here at home, and whatever industries we might lose in this country we can afford to lose. I don't buy that one either.

What is on the line is important sectors of our economy. The United States must have a balanced, strong industrial base; without that base, we cannot have a vigorous economy or retain our security.

The U.S. goods-producing sector is in trouble, and the trouble is getting worse. We in business cannot deal with these problems by ourselves. When the ox is in the ditch, everybody has to help pull him out, and we need your help.

I am not here to plead for subsidies or preferential treatment, although in a few extreme situations, special Government action will indeed be necessary. I am here to ask Government to deal with the basics—to get the budgets under control, to bring the dollar down in exchange value, to reframe the tax laws so that U.S. firms can meet their competitors on even terms, and to insist that other countries offer equal access to their markets—not just in theory, but in practice.

Finally, I believe we all must recognize that even if we are successful in negotiating better trading arrangements, we cannot cram enough telecommunications equipment, forest products, beef and orange juice into Japan to eliminate our current trade deficit. Meeting more of our own Nation's needs from our own production is a necessary part of the long-term answer.

Thank you, Mr. Chairman.

Chairman LAFALCE. Thank you, Mr. Heckert.

[The prepared statement of Mr. Heckert follows:]

TESTIMONY

BY

RICHARD E. HECKERT

VICE CHAIRMAN

E. I. DU PONT DE NEMOURS AND COMPANY

BEFORE THE

U. S. HOUSE OF REPRESENTATIVES

SUBCOMMITTEE ON ECONOMIC STABILIZATION

OF THE

COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS

APRIL 16, 1985

My name is Richard E. Heckert, and I am vice chairman of the Du Pont Company.

The point that I will make today is that our nation's economic and trade policies must be adjusted to support rather than detract from industrial competitiveness. This country's well-being and the future of international trade depend on it.

Governments profoundly affect the ability of their industries to compete in both domestic and overseas markets, and in the U.S. that influence has been largely negative for some years. Trade problems have had low priority in the development of economic policy, and our industrial infrastructure is being hurt badly.

The costs to the nation are already high, and the current trend, if it continues, can only produce extremely serious consequences. This will include the export of more jobs from the U.S. workforce; an economic recession -- which is likely to be severe and protracted; a return to high rates of inflation; and an overly protectionist trade policy, for which the pressure is already building. These are not effects that are going to show up overnight, but the other side of that coin is that, once the damage is done, it will take a good many years to repair it, if indeed it can ever be fully repaired.

It is not just a few old-line industries that are in trouble, but all of the key industrial sectors including the so-called high-technology fields, plus agriculture. For all their many strengths, the goods-producing industries in this country are less able to compete in world markets today than at any time since the end of World War II.

It would be economically foolish to let the situation continue, and I believe it would be strategically dangerous as well as politically unwise. It is also unnecessary -- because we have the power to change the situation.

Let me expand briefly on those points.

There have always been ups and downs in the economy, and that's not the problem. A minor shift in trade or monetary policy, or an unexpected change in the market, has enabled some companies to get ahead while others lost out. Business has always lived with perturbations of that kind.

Our nation, like many others, has become steadily more involved in international commerce. In other countries there have been improvements in technology and productive efficiency, and that has helped in their pursuit of global markets. It is now estimated that 70 percent of the goods produced in this country have foreign competition, either here in the U.S. or in markets abroad, or both. We can live with that, too: Competition can be good for all concerned.

Real trouble develops when companies are overwhelmed by forces they cannot control, and when competition has extraordinary advantages that cannot be wholly offset simply by working smarter or investing in new equipment. This is the position U.S. industry is in today.

The most important single problem for us, in the past few years, has been the rise in the exchange value of the dollar versus other major currencies. There are several, sometimes interrelated reasons for the strong dollar, including high real interest rates necessary to attract funds to cover the growing Federal deficits. In less than five years the dollar has gone up more than 50 percent relative to the composite index of other currencies. It has more than doubled versus the key currencies of Western Europe. What that means is that products being imported into the U.S. arrive here with a large price advantage, in effect a subsidy, while the U.S. products we try to sell abroad carry a large penalty.

The dollar is one factor. Another is U.S. trade policy. Our government has consistently pressed toward free-trade arrangements; but most other nations do not run free-trade economies. Instead, they use subsidies, quotas, government procurement practices, domestic-content rules, targeting practices, and other tariff or nontariff barriers to give their own producers the advantage.

There are all sorts of reasons why the U.S. followed the policies that it did, dating back to the beginnings of the GATT agreements. There was a strong belief in this country that, if the markets were opened up, true comparative advantage would come into play, and that would produce a better world. It can also be said, a little more cynically, that in the years immediately after World War II, America was in a unique position of strength, and we could afford to be magnanimous. Motives aside, the fact remains that we did open up the U.S. market to foreign producers on very favorable terms, and we did not obtain matching trade opportunities in return. This has led to unbalanced arrangements, the shining example of which is our trading relationship with Japan. That's the example that most irritates Americans today, but it is not the only case. There are also problems in Europe, Canada and other important market areas.

Put those problems together with the high trading value of the dollar, and you buy the headaches we have now. U.S. exports have been flat while imports have been soaring, and last year the U.S. ran up the largest trade deficit any country has ever recorded. The forecast is that it will be even higher this year (even without allowance for the added number of cars that the Japanese have now decided to sell in the U.S.).

Everyone is familiar with the problems of steel, but that is only the tip of the iceberg. Most industries are now involved. The industries that government labels as technology intensive (chemicals, machinery and equipment, transportation equipment, science and business equipment, and ordnance) had a $27 billion trade surplus in 1980; last year that number was down to $5 billion.

The U.S. chemical industry has been a world leader for many years, and has routinely been a large contributor to a favorable balance of trade. However, many of our export businesses are now unprofitable, and the trade surpluses we generated prior to 1980 have been cut by one-third.

Agriculture is another area where the U.S. has been a consistent leader in efficiency and productivity, and, there too, the export surplus has declined.

I think it is clear that we in the private sector have to do everything they can to make ourselves more competitive. This calls for more and better R&D, aggressive capital spending, better marketing, and better use of people throughout our operations. We're working hard on those points. However, by ourselves we cannot close the gap that has been created by the runup in the value of the dollar.

A few specific examples:

My company makes "Mylar" polyester film in South Carolina and Ohio, and we also have a subsidiary company making the same product in Luxembourg. The plants are fully modern and comparable in efficiency; yet when the costs are translated into dollars at current exchange rates, we find that it costs 20- to 25-percent less to make "Mylar" in Europe than here. We can import "Mylar" from Europe, pay the freight and duty, and sell it profitably at a lower price than our domestic product.

"Teflon" fluoropolymer resin is another Du Pont example. We can import it from our plant in the Netherlands, with a 20-percent cost advantage over the "Teflon" we make in West Virginia.

We make a plastic called "Delrin" acetal resin. The cost difference between Europe and the U.S. is 40 percent, and, again, the plants here and there are almost identical twins.

There is no way we can offset such large cost differences by squeezing the production process harder here in the U.S. We can bring in new technology, and that is being done by most companies, but remember that the same new technology can also be utilized in plants overseas -- so the water level goes down in both tubs.

The textile industry is taking an especially tough beating. Many people view textiles as an old-line, labor-intensive, unsophisticated industry. The fact is that the leading textile makers have spent hundreds of millions of dollars modernizing their U.S. plants, and introducing remarkable technological improvements. Yet that industry is literally being taken apart by imports. Last year alone, the imports grew by 33 percent, while the production of U.S. textile mills declined (by 1.6%). Nearly one-half of the apparel sold in the U.S. today comes from abroad.

The impact on employment is severe. This industry employs one out of every 10 manufacturing workers in the U.S., and it is one of the largest employers of women, blacks, and Hispanics. Many of these people are at the lower end of the income scale, where unemployment generally causes the greatest personal hardship. About a half-million jobs have been lost in the U.S. textile industry in recent years.

On an all-industry basis, the strong U.S. dollar and related problems have cost the country an estimated two million jobs, and that number will grow unless something is done about it.

A great deal can be done.

Our biggest problem is the exchange value of the dollar. If government can reduce its budget deficits and rationalize fiscal and monetary policies, that would help bring down real interest rates, and then the dollar should move downward toward purchasing power parity. Of all the steps that might be taken to improve America's competitiveness, I rank this one first in importance. If the dollar came down, I firmly believe that most of our international trade disadvantage would go away. If the dollar does not come down in trading value, by a substantial amount, nothing else that government does is likely to be of much help in improving industrial competitiveness.

Second, tax and regulatory policies have to be reexamined, and in some cases reformulated, to reflect the realities of international competition. The tax system as presently designed is anything but neutral with respect to trade. For the most part, other nations encourage savings and investment more than we do. We focus taxes on income. Other countries apply more of the burden to domestic consumption, through national sales or value-added taxes. They apply these taxes to products consumed domestically and excuse them on exports. That gives a boost to their exporters in world markets. By contrast, U.S. exports carry substantial social cost, a burden not imposed on imports. What we have is not a tax policy that is pro-trade, but one that is pro-imports and anti-exports.

It is common in other countries for industry to writeoff its costs for new plant and equipment in a year or two. In the U.S. the depreciation allowances stretch out over much longer periods of time. That is one factor that makes the cost of capital higher in the U.S. than abroad. It tends to discourage investment. To compound the problem, we have burdened ourselves with real interest rates far above historic levels, which have made our cost of capital still higher. Furthermore, many U.S. plants have had to compete with foreign plants built with outright capital grants from governments. We have to play the game with our own money; some of our international competitors play with one hand in their Federal till. I don't think many people in this country realize that if Du Pont wanted to build certain kinds of new plants today, the governments of some other countries would pay one-quarter or one-third of the construction costs for us.

In the tax proposals that came from the U.S. Treasury Department a few months ago, it was proposed that the investment tax credit be cut and the depreciation allowances be stretched out. I am not sure how much support that idea has in Congress, but I can assure you that this is exactly what the nation should not do to improve its trade position. The very fact that Treasury has proposed such a move is evidence that many people in government still are not thinking enough in international terms. They are still trying to run the economy as if the U.S. were an island, when in fact many of our companies and employees are fighting for survival in an international marketplace.

As a third and final point, I believe we must take a much tougher stance in our trade relationships with other countries. We should send a strong signal to them that we are going to do whatever is necessary to bring our imports and exports more nearly into balance. At bare minimum, we should insist that, if others wish to continue to have access to the U.S. marketplace, the companies located here must have comparable trade and investment opportunities in the markets outside the U.S. Some countries will not allow outside companies to do business within their borders o the same terms as their domestic companies enjoy.

In recent months there has been much talk about reducing trade barriers in other countries, notably Japan. In our industry, visible barriers are not the problem in Japan. The Japanese have an excellent understanding of what is good for them. They readily buy from us those things not available at home, and strongly favor their own suppliers for everything else. That strong sense of the national good is lacking in the U.S.

In multilateral and bilateral negotiations, we should look for more of a quid pro quo. We should clamp down harder and faster on cases of dumping, and other infractions of the rules. In short, our government should declare that America's long-term economic interests will be the primary goal of our trade policy. All sectors of government should pursue that policy in a consistent and coordinated way, and we should not apologize for acting in self-interest, for that is precisely what our competitors have been doing for years.

Our friends abroad argue that we cannot close our markets to them, because they must export to survive. For some countries, that's true. The U.S. is more fortunate, though, and this puts us in a position to deal from strength: We do not have to export to survive, but only to be able to cover the costs of our imports; and other countries have no inalienable right to the marketplace here.

The main point to keep in mind is that the trading system has to benefit all the parties in it. It cannot survive if the gains consistently fall to one side at the expense of the other.

I hear it said that the U.S. cannot take aggressive action because other countries will retaliate, and then we will have an all-out trade war. I don't buy that. Other countries have much more to lose by such a confrontation than the U.S. has, and they know it.

I hear it said that all our problems will ease and eventually disappear as we rearrange our domestic industries and put more attention on our own productivity. The presumption is that, whatever industries we might lose in this country, we can afford to lose. I don't buy that one either. What is on the line are some of the largest and strongest sectors of our productive economy. There is no way that the U.S. can have a vigorous and growing economy, or retain its security, without them. This country must have a balanced, strong industrial base. -

The U.S. goods-producing sector is in trouble, the trouble is getting worse, and we in business cannot deal with the problems by ourselves. When the ox is in the ditch, everybody has to help pull him out.

I am not arguing for special subsidies or preferential treatment, though I believe that in a few extreme situations, where security or the overall health of the economy is involved, such action may be necessary and justified. Those kinds of problems have to be addressed case by case.

What I am asking is for government to deal with the basics -- to get the budgets under control, to bring the dollar down in exchange value, to reframe the tax laws so that U.S. firms can meet their competitors on even terms, and to insist that other countries offer equal access to their markets. In other words, I am arguing the case for economic and trade policies that are in line with the realities of a world of international competition.

As a final point, I believe we all must recognize that, even if we are successful in negotiating more equitable trade arrangements, we cannot cram enough telecommunications equipment, forest products, beef and orange juice into Japan to make a serious dent in the current overall trade deficit. Meeting more of our nation's needs from our own production is the only long-term answer.

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4/16/85

Chairman LaFalce. Our next witness will be Mr. Lawrence Fox, the vice president for international economic affairs of the National Association of Manufacturers. Mr. Fox, I'll ask you to try to keep your remarks to no more than 10 minutes, if you could.

STATEMENT OF LAWRENCE A. FOX, VICE PRESIDENT, INTERNATIONAL ECONOMIC AFFAIRS, NATIONAL ASSOCIATION OF MANUFACTURERS

Mr. Fox. Thank you very much, Mr. Chairman.

NAM represents about 85 percent of U.S. manufacturing output and 80 percent of employment in manufacturing. I am happy to be here today to explain the viewpoint of U.S. manufacturers with respect to our problems in the trade area.

I would like to focus my comments on the exchange rate. Ambassador Brock, our Trade Representative, has recently told a group of American businessmen, including NAM, and foreign business leaders, that in his opinion, the exchange rate accounts for 80 percent of the U.S. trade deficit.

I think the figures that are used universally always put it at at least 50 percent or more.

I would like to quote Dr. Otto Eckstein, former member of the Council of Economic Advisers, in a report issued shortly before his death. So I'll quote him, and that will be my only quote for today:

> No degree of cleverness on the part of management, no new-found cooperation between employees and workers, no industrial policies by the federal government can overcome the burden of an over-valued dollar in a domestic economy dissipated by credit crunches and recession every three or four years.

It is in that context that I make my comments with respect to the exchange rate.

According to the last report of the Council of Economic Advisers, the dollar has now risen 65 percent above the level of 1980 based on the Federal Reserve Board's index of comparisons with 10 leading industrialized countries.

If you look at the first chart—it's in a small form at the back of my statement, but it's over there, too. I draw your attention to global manufactured trade balances between the United States and our two principal competitors in that area—Japan and Germany (exhibit No. 1).

Starting in 1970, the U.S. had a slight trade surplus of $2 to $3 billion. During the decade, we had dipped below and we had risen above, but we were still roughly at the point of zero at the end of the decade.

Germany and Japan each started in 1970 at about $15 to $16 billion, and now Japan has a global surplus in manufactured goods of over $120 billion, and Germany, about $60 billion.

You'll see the big drop that begins in 1981. That's the period when the high dollar began to take effect. And, last year, the deficit in manufactured goods was $90 billion and dropping rapidly.

From a sectoral point of view, to summarize quickly, I suggest you take a look at exhibit No. 3, which gives the major sectors of our trade and what has happened. I will just summarize.

For capital goods, at one time the heart of our trade surplus position, in 1980 it was plus $43 billion; in 1984 it had dropped to plus $12 billion; and this year it is likely to be zero.

High technology, in 1980, plus $28 billion, this year it has dropped to $9 billion and is still dropping.

Automotive products, which we know have not done particularly well, including automobiles—1980, minus $11 billion; 1984, minus $33 billion.

Consumer goods, likewise an area that we know has not done particularly well, minus $18 billion in 1980 to minus $47 billion in 1984.

And industrial supplies and materials, excluding oil, from a plus $16 billion in 1980 to a minus $9 billion in 1984.

If I might take one sector that is commonly cited as sort of a white hope, the high technology sector, let me give you some detailed figures on commercial telecommunications.

In that category, exports in 1980 have gone from $10 billion to $14 billion. Not too bad, a 40-percent increase. But imports have gone from $12 billion to $28 billion; that is, more than doubled on the import side.

A serious deficit of $2 billion has grown to a staggering deficit of $14 billion, and we still find ourselves unable to sell to NTT, the Japanese telecommunications company, even though its present status is that of a deregulated company in that country.

I would like you to look at the second chart, which is exhibit 2. Exhibit 2 compares our trade balance and our current account balance and shows the rapid deterioration that has taken place since 1980 or 1981.

What this says is our international accounts are in fundamental disequilibrium and the lines are still going down. One can draw the conclusion from that that unless we can turn around the trade account the situation is close to hopeless.

What used to be an important source of foreign earnings, the difference between the blue and the red line; namely, private investment earnings abroad and other earnings from services, is rapidly turning into a deficit. That is because the U.S. Government is selling its debt securities to foreigners and financing an unprecedented portion of the budget deficit with foreign money.

The statement that you made, Mr. Chairman, at the beginning with respect to the importance of foreign debt and its effect on the ultimate decline in our standard of living is absolutely correct, and I think what we have in the current account chart there is an indication of a situation that is unsustainable.

In other words, we are borrowing abroad to finance our own budget deficit. That is the sort of governmental approach to budgets in Latin America that has led to the financial problems that we refer to generically as the developing country debt problem.

I would like to give you at this point my judgment as to how best to deal with the exchange rate problem. In the text that you have, I have an exhibit which reproduces an NAM statement of April 10 on a program to deal with the exchange rate problem (exhibit No. 6). I am not going to summarize it. It is summarized in the text. I am just going to hit a few highlights.

No. 1, do something, and something serious, about the budget deficit. Mr. Heckert has already explained why.

Second, undertake policies that will encourage economic growth abroad, particularly in Europe and Latin America, traditionally very important markets for our goods.

Third, speed up the internationalization of the yen. Domestic financial markets in Japan are still controlled, and Japan deliberately maintains a dual interest rate system with lower interest rates in Japan for the benefit of Japanese business and other domestic users of credit. Japan, although it has liberalized to a degree, particularly on the external side, basically is not part of the international monetary system and its financial markets are not open to the extent that New York, Frankfurt, Zurich, and London are open markets. Japan has access to financial markets abroad, but others do not have equal access to the financial markets in Japan.

Fourth, take steps to decrease the unnecessary use of the dollar. There is really no reason why, when the Europeans settle accounts between themselves—say between France and Germany—they should go through the dollar and artificially create demand for dollars. The Europeans are trying to do that. I think we ought to try to help.

There ought to be greater use in transactions and in reserves of the currencies of Japan and Germany and perhaps one or two other countries. There is an artificial demand for dollars that bids up its price, created by the use of the dollar as a currency of convenience. Wider use of the yen and the mark in international transactions would tend to increase the price of these currencies relative to the dollar.

Fifth, the Treasury ought to explore the possibility, to the extent that it has to borrow abroad, of borrowing in marks and yen. That will increase the demand for those currencies. If they don't increase the supply, the price ought to go up. It is one direct means of dealing with the problem of strengthening those currencies. We should not constantly talk about depreciating the value of the dollar. Those other currencies have to strengthen.

Sixth, in cooperation with other countries, we ought to take steps to improve the coordination when it is desirable or necessary to intervene in currency markets. With Germany, for example, take steps to make the mark closer to a value that the German central bank thinks is reasonable; in other words, to increase the value of the mark.

The Secretary of the Treasury ought not to make a statement in the middle of a German currency operation that intervention never works. I think we have had that kind of statement from the previous as well as the present Secretary of the Treasury.

The purpose of cooperation in currency matters with other countries is not to overwhelm the markets. The purpose is to play a strategic game with a specific purpose, with an objective to be achieved. It need not be announced. It is probably better not to be announced. It will be evident, then, that the currencies are not on a one-way track, and it will cause others to view the U.S. policy in the currency area as having some meaning.

In addition to budgetary and monetary policy, we need an exchange rate policy. Every other government has an exchange rate policy. We need an official view as to what the dollar really is worth and should be worth relative to our needs in trade and in other aspects of our international accounts, as well as in our domestic markets.

I think now would be a good time, in cooperation with other countries, particularly following the OECD ministerial meeting and in preparation for the Bonn summit, for us to—for our central banks, the Fed, and the central banks of other countries to learn to cooperate a little bit and plan how to intervene effectively. The United States has forgotten how to do it.

Perhaps the objective immediately ought to be to cap the dollar at its present level and then see how that works before we outline longer term changes in the international monetary system. But longer term changes are needed, I am convinced.

I think doing the right things on our budget deficit, on our monetary policy, in conjunction with some better economic convergence policies of other countries are important preconditions, but I am convinced that the present floating exchange rate system is hopelessly flawed. I think a longer range look at reform of that system has been indicated by Secretary Baker as one of the things that he is willing to do, and I think he should be given encouragement to that end.

I am convinced that if we take the necessary steps in budget policy and fiscal policy, work toward an improvement of the operation of the exchange rate system, we have a good chance of coming out of this mess without either a terribly serious recession in the United States or a worldwide recession.

In any case, doing the right thing with respect to the current account, which means our international accounts generally, should prolong the recovery in the United States and give greater confidence to the rest of the world that we intend to put our economic house in order here and that we are going to work seriously toward an improvement in the world trade system, and that means in the direction of a system that is more open, if possible.

I conclude with the observation that there are things to be done beyond monetary steps in the international field and the macropolicies I have referred to. I will just tick them off for the purpose of completeness.

The U.S. Government ought to eliminate the barriers that it itself has created to U.S. exports, and notably improve the Export Administration Act.

Second, we ought to improve—the U.S. Government ought to help to improve our access to foreign markets. That is notably the case with respect to Japan, but it applies to many other countries.

Third, there is room for improvement in the international trading system. There are new conditions to be dealt with in the world since GATT was created—protection of international property rights, greater attention to government intervention through industrial policies and through other means, and subsidies that directly relate to internationally traded goods. These problems can be dealt with more effectively through improved and updated GATT rules.

And then finally, I would indicate that we have a need to seek fairness in its most general sense. I don't use the term "level playing field" very often, but it summarizes the point of view that I wish to express.

The President's Commission on Industrial Competitiveness, chaired by John Young, has made recommendations as to steps to be taken in the internal economy, including steps relative to R&D, antitrust, and other matters, and I think these recommendations should be given serious consideration because the world does not stand still. Other countries are improving their competitiveness every day, and I think the President's Commission on Industrial Competitiveness has identified a number of things we could do in our own internal economy to improve the competitiveness of our industry.

Thank you.

[The prepared statement of Mr. Fox, on behalf of the National Association of Manufacturers, and an article from Trade & Industry of January 18, 1985, entitled "U.S. Competitiveness and the Trade Deficit," follow:]

TESTIMONY OF

LAWRENCE A. FOX
VICE PRESIDENT, INTERNATIONAL ECONOMIC AFFAIRS
NATIONAL ASSOCIATION OF MANUFACTURERS

ON

THE DOLLAR EXCHANGE RATE AND THE U.S. TRADE DEFICIT

BEFORE THE

SUBCOMMITTEE ON ECONOMIC STABILIZATION
OF THE
COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS
U.S. HOUSE OF REPRESENTATIVES

APRIL 16, 1985

Mr. Chairman, members of the committee, I am Lawrence A. Fox, Vice President for International Economic Affairs of the National Association of Manufacturers. NAM is the nation's oldest national trade association, with membership of more than 13,000 companies, ranging from the smallest to the largest companies in the United States. Together they account for approximately 85 percent of U.S. industrial output and more than 80 percent of U.S. industrial employment.

There is no more important subject today than the relationship between the U.S. economy and the global economy. I commend the Committee for calling these hearings and appreciate very much the opportunity you have given me to state NAM's views.

Much has been said and written over the past few months regarding last year's unprecedented $123 billion U.S. trade deficit and its relationship -- both cause and effect -- to this country's economic competitiveness. Today, I want to focus particularly on one aspect of the trade deficit and the competitiveness problem, namely the interrelationship with the overvalued dollar.

It is universally conceded that the high dollar is now the principal cause of the continuing increase in the trade deficit, as well as the competitive problem U.S. industry is facing in both domestic and foreign markets. U.S. Trade Representative William E. Brock recently stated before a group of American and foreign industrial leaders that he estimates that the high value of the dollar accounts for 80 percent of the current trade deficit. Whatever we do to resolve our competitive difficulties, nothing will work unless and until we have success in dealing with the overvalued dollar. To quote from the late Otto Eckstein, in a report on U.S. manufacturing industry competitiveness published last year by Data Resources Inc.:

> No degree of cleverness on the part of management, no new-found cooperation between employees and workers, no industrial policies by the federal government can overcome the burden of an overvalued dollar and a domestic economy dissipated by credit crunches and recession every three or four years.

The Trade Deficit and the High Dollar: Scope and Consequences of the Problem.

I start with the premise that the trade deficit is terribly serious, is undermining the industrial base of the nation, and ultimately if left unattended will lead to protectionist "solutions" that will have grave consequences for this country and our friends and allies abroad. The problems which created a $123 billion overall trade deficit in 1984 and a manufactures trade deficit of almost $90 billion ($50 billion higher than in the previous year) are long-term, not short-term. This includes notably the misalignment of the U.S. dollar against all major currencies.

This year's Economic Report of the President noted that by the end of 1984, the exchange value of the dollar, as measured against the currencies of the world's ten other leading industrial nations, was 65 percent higher than in 1980. This is the fifth year of the high dollar. This situation has persisted despite U.S. trade and current account deficits on an unprecedented scale and many predictions of a rapid fall in recent years -- and despite the fact that the basic premise of the floating rate system is that large current account deficits will lead to an automatic and self-correcting fall in the value of a country's currency.

Furthermore, let me state at the outset that I do not subscribe to the pollyanna view that the high dollar brings benefits to our economy which outweigh the negative impact on U.S. trade. It may be true, that by making imports cheaper the high value of the dollar has helped hold down inflation during the present economic expansion. But record-breaking levels of imports and high domestic interest rates, while they may keep inflation under control, are transforming the economic structure of this country. Initially, these changes were not readily apparent because of the general effects of rapid growth. But the slowing of growth over the last three quarters plus the generally unexpected continuation of the dollar's rise in 1984 and early 1985 have brought about greater recognition of the widespread and permanent damage that has occurred to the U.S. industrial base. Additionally, the negative effects on agriculture and mining are of major importance.

Let's look first at trade in major manufactured goods sectors. This country has essentially lost its edge in high technology and capital goods. As recently as 1981, the U.S. had a surplus in manufactured goods trade. The first large chart that I have here, global trade balances in manufactured goods (Exhibit 1), indicates how the U.S. surplus has fallen by nearly $100 billion in just four years, while our major competitors, the Japanese and the Germans, have expanded or maintained their surpluses. In contrast with a U.S. manufactured goods deficit of $90 billion last year, Japan had a global surplus of over $120 billion and Germany of $60 billion. As shown in the chart in the appendix on sectoral trade balances in manufactures (Exhibit 3), our $46 billion surplus in capital goods in 1981 more than offset the deficits in consumer goods and automotive trade. But last year, our surplus in capital goods was down to just $12 billion, while the deficits in consumer and automotive products totalled $80 billion. This year, Commerce Department chief economist Robert Ortner has predicted an actual U.S. deficit in capital goods. Looking at a different type of measurement, we see on the same chart in Exhibit 3 that our trade surplus in high technology products fell from a high of $29 billion in 1981 to about $9 billion last year. The details of this trade performance, Mr. Chairman, are contained in the trade competitiveness analysis published by our report Trade & Industry on January 18, which I am also submitting for the record.

The high dollar, Mr. Chairman, exaggerates the impact of adverse trade swings on the most competitive sectors of the economy. Let me cite some numbers to back this up. A recent article by senior international economist David Lund for the Commerce Department publication Business America compared import penetration ratios for non-automotive consumer durables and capital goods between 1970 and 1984. In 1970, about 8 percent of our capital goods and 10 percent of our consumer durables were imported. Both numbers increased steadily over the following decade -- by 1980, capital goods imports were 16 percent of the market, compared to 13 percent for consumer goods. The subsequent rise in the dollar has accelerated the rise in imports' real market share, but in capital goods where the U.S. has seen its strongest domestic growth due partly to tax law changes, the real import share is now nearly 26 percent compared to just 17 percent in consumer goods. And some other estimates indicate that capital goods imports may be more in the 30-40 percent range of total consumption.

My conclusion is that under the conditions of rapid import growth, cost-conscious capital equipment renewal and an overvalued dollar, it is in our most competitive capital equipment and high technology industries that we have see the greatest erosion of our competitiveness. By contrast, the rise of import penetration numbers in industries already troubled by import competition before the last recession -- such as cars, steel and textiles, is not so steep, due in part to quota systems which have already been in place.

Finally, it is clear that these developments are having an impact on the dynamics of an overall recovery. Exports did recover by 9 percent in 1984 over 1983, but were still lower by $16 billion than in 1981. Import growth overwhelmed exports, increasing by 27 percent overall in 1984 -- and 36 percent in manufactured goods. It is not surprising therefore that factory orders, industrial production and manufacturing employment have all fallen or slowed dramatically in growth since mid-1984. Moreover, capacity utilization, which normally peaks near 90 percent in a boom year, in this growth period has apparently topped out at around 82 percent, according to statistics in the Annual Report of the Council of Economic Advisors. Part of this could be due to the transfer of production to lower cost, excess capacity or new facilities abroad. We do know, of course, that the latest Commerce Department estimates of planned capital expenditures for U.S. affiliates abroad show a planned 22 percent increase in manufacturing investment for 1985, compared to four percent for 1984 and declines in 1982-93.

"Benign Neglect" Will Not Solve the Problem in the Current Account

There is an argument that the rising dollar and the growing trade deficit reflect an evolution of the U.S. role in the world economy that it would be unwise to try to stop. As the dollar rises due to strong capital inflows -- instead of falling due to the trade and current account deficits -- the U.S. role in the world economy will become less a supplier and exporter of manufactured goods and increasingly a provider of services. However, this chart on the U.S. balance of payments and the trade balance (which is labeled

Exhibit 2 in your packet) indicates that this viewpoint, which I would label "benign neglect," is very dangerous.

For the past decade, the non-merchandise trade factors in our overall balance of payments have substantially buffered or reduced the impact of regular large trade deficits. Since 1976 the overall balance on current account has usually been $20-30 billion more favorable for the U.S. than the trade deficit, as measured on a balance of payments basis. Often, the net result was a positive current account balance despite the trade deficit. The most significant feature of the 1984 numbers is that we have lost this cushion. Due to substantial falls in our net earnings on investments and services, the total current account deficit was almost as large as the deficit in goods trade alone -- $102 billion against $107 billion, if the latter is measured on a "balance of payments" basis.

The $100 billion-plus 1984 current account deficit together with a deficit of over $40 billion in 1983 have created a requirement for nearly $150 billion in net foreign capital account inflows and most predictions are for an even greater current account deficit this year. Normally, a country's currency exchange rate declines in this situation, thereby reducing imports, boosting exports and narrowing the current account gap. The reverse reaction in the U.S. case has stimulated even larger current account deficits and net capital inflows. Our net positive world investment position, built up since the First World War largely by our private banking and industrial sectors, has now turned into a net debtor position.

To a great extent, this change has been accommodated by the ending of American bank loans abroad -- down from $111 billion in 1982 to a net of just seven billion dollars last year. However, new private capital inflows have continued at a rate of $80-100 billion annually in each of the past four years, to which must be added a "statistical discrepancy" that consists mainly of unrecorded capital inflows and that was $30 billion in 1984. An increasing share of all these capital inflows is going directly into buying government debt issues. Moreover, former Council of Economic Advisers Chairman, Martin Feldstein, has made the point that all capital inflows help support the federal budget deficit burden because they contribute to the national capital pool. These inflows reduce the capital available to stimulate domestic investment and growth in our trading partners, especially the less developed countries. They also create a rising interest repayment burden which will make it difficult to balance against the current account.

In stark terms, the private sector has been losing earnings in trade and in foreign investment income due in large part to the high dollar, causing the huge current deficit. The Government is compounding the problem further by financing an increasing part of the federal budget deficit (directly and indirectly) by borrowing foreign capital. Ultimately this debt to foreigners has to be serviced by interest payments and in part paid back. Note this figure: in 1984 the government paid $19 billion in interest to foreigners holding federal debt.

To offset these payments in the current account, we must improve our trade performance. The best way to do this, without adopting restrictive measures to hold down imports, is to seek, in cooperation with other major industrial country governments, ways in which to insure that the dollar's exchange value will reflect more accurately the international competitive position of U.S. industry, agriculture, and mining as indicated by the balance of payments on current account.

NAM Program to Deal with the Overvalued Dollar

In February 1984, Mr. Chairman, the NAM Board of Directors unanimously passed a resolution expressing its concern with the impact of the high dollar exchange rate on U.S. trade performance and proposing a comprehensive program to deal with this problem. Recently the State Department requested comments from NAM regarding the continued high value of the dollar and the policy changes which might be necessary to make the dollar more reflective of the international competitive position of U.S. industry. This request was related to planning for the forthcoming Bonn Economic Summit. Unfortunately, relatively little of the program recommended by NAM's Board last year has yet been implemented. Our response to the State Department has focused on how the steps recommended last year might be updated and implemented to provide a program that we believe the U.S. government should carry to the Bonn Summit in May. I would like to ask that both the 1984 NAM Board Resolution (Exhibit 5) and a statement which summarizes our response to the State Department's request this year (Exhibit 6), be added to the record of my testimony.

Since I am including these statements in their entirety, I will only summarize our program here.

First, I want to relate our program to the causes of the high value of the dollar. A combination of several different factors have caused the high dollar and these factors have changed in relative weight during the past four and one-half years. While the rise of the dollar actually began in an environment of relatively poor U.S. economic growth, followed by a deep recession, there is now a worldwide perception of the strength of the U.S. economy and the relatively poorer economic performance of most the rest of the world. High real interest rates in the U.S. relative to other countries have obviously been very important in attracting capital inflows, regardless of the weight one gives the federal budget deficit as a major cause of high interest rates. Finally, no one wants to cure the dollar exchange rate problem by inducing inflation at home or a recession in the domestic economy.

Our first major step should be to reduce significantly the U.S. federal budget deficit. There is a possibility, of course, that the dollar might temporarily rise even further if we achieve action on the deficit. This risk is offset by the obvious benefits of deficit reduction. It will be very difficult or perhaps impossible to establish a general pattern of growth worldwide and lower interest rates unless the U.S. budget deficit is reduced.

Second, we should encourage policies conducive to sustained growth in Europe and the less-developed countries, especially Latin America. Historically, these countries are among our leading export markets. Our exports cannot grow in a vacuum, and only widespread global recovery can establish the conditions necessary for a robust recovery in U.S. manufactures export growth, whatever the exchange rate of the dollar.

Third, we must undertake steps immediately in cooperation with the central banks and finance ministries of other countries to help assure that the dollar is heading in the right direction on world exchange markets while improving the operation of the present floating exchange rate "non-system." The best approach is to begin with the objective of capping the dollar. The fact that the dollar is down from its recent peak makes such an approach particularly feasible at this time.

This step of capping the dollar could best be done in conjunction with achievement of a successful U.S. budget deficit cut of $50-60 billion, but technical work should be started by central banks without delay. Possibly, we should avoid announcements of currency actions, to lessen the risk of excessive expectations or early failures. In any case, currency markets have to be convinced that the U.S. has made a major policy decision to assert the importance of its national interest in trade. The world trade community will see U.S. exchange rate action as a major step to help stop the spread of protectionism and to move toward more open international markets for goods and services.

In effect, the U.S. has already agreed to such cooperation at the Williamsburg Economic Summit in 1983 and again in the January 17, 1985 "G-5" statement, but U.S. leadership or participation has been sporadic despite these agreements. Perhaps last week's agreement in Paris at the Ministerial meeting of the

OECD (Organization for Economic Cooperation and Development) is evidence of a turning point regarding the U.S. Government's viewpoint on the exchange rate.

The purpose of NAM's program of cooperation in exchange markets is not to overwhelm the markets, but to play a strategic game in cooperation with other countries. Currency markets should know that the U.S. has an "official view," even if unstated, as to the value of its currency, and an exchange rate policy to back this up. Regarding the view that currency markets are too big to be influenced without massive intervention, it has recently been estimated that true long-term flows on exchange markets are less than $500 million per day. This means that calculated, coordinated moves by central banks may have much more impact than commonly believed.

Fourth, the U.S. should initiate consultations leading toward longer term reform of the floating exchange rate system. This longer term effort will help reinforce the short-term efforts described above. It will give credence to the view that the U.S. is serious about adding exchange rate policy to fiscal policy and monetary policy as macro-policy elements. In such discussions, we should not be too dogmatic about what conclusions we will reach, although any consideration of a return to fixed exchange rates or generalized capital controls should be discounted from the outset.

Fifth and finally, no program to improve the operation of the international exchange rate system will fully succeed without the incorporation of the yen as a true international currency. We must therefore speed up the internationalization of the yen. The

U.S.-Japan financial agreement of May 1984 provides the basis for more decisive action by Japan. Especially needed is prompt action to free up domestic financial markets in Japan. The Japanese government should also create the necessary financial instruments (e.g. Treasury bills) so that foreigners can use Japanese financial markets as freely as Japan uses the financial markets in New York, London, Frankfurt and Zurich.

Other Measures to Improve U.S. Trade Performance and Industrial Competitiveness

In this testimony and in other forums I have insisted that no positive measures to reverse the U.S. trade deficit are likely to work satisfactorily without an effective program to readjust the dollar exchange rate. But that does not mean we can ignore these other measures. Far from it -- the U.S. trade deficit has assumed such large proportions that it is essential that the Administration and the Congress take a number of other major measures to address trade problems. Potentially, the most important of these measures are the following:

- Eliminate the barriers to U.S. exports that we ourselves have erected. For example, the President's Commission on Industrial Competitiveness has estimated that foreign policy and national security controls now annually cost the U.S. over $12 billion in lost export sales. We urge Congress to pass H.R. 28, the export control reform bill now moving through the House, as a major step toward overhaul of our export controls.
- Improve U.S. access to foreign markets through direct negotiations with our trading partners, notably Japan.
- Improve the international trading system. We strongly support the President's call for a new round of multilateral trade negotiations. In our view, a new GATT round should at least aim to achieve: discipline over national industrial policies that distort trade

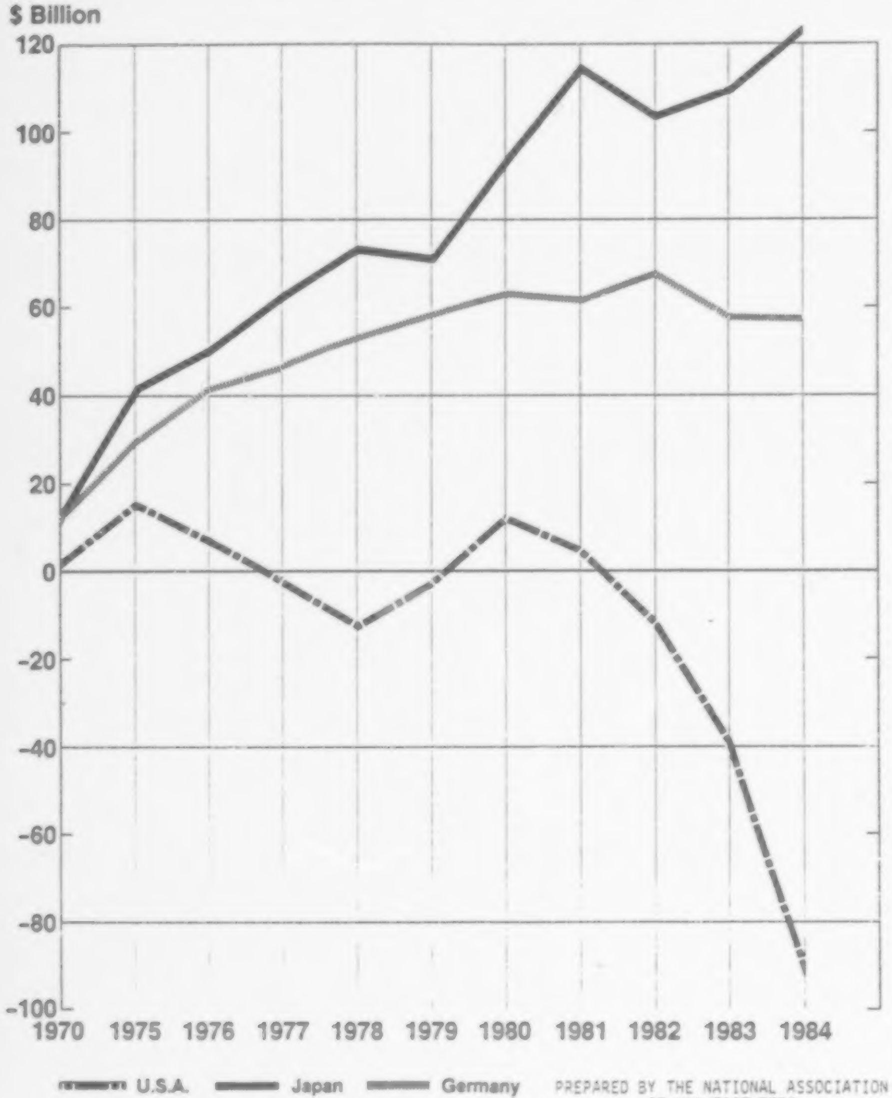
flows; a better dispute settlement mechanism; a transparent "safeguards" code to deal with sectoral trade restrictions; improved Government Procurement and Technical Standards Codes; more effective redress of counterfeiting violations with generally better protection for intellectual property; and a meaningful set of rules for trade in services.

- Indicate our determination to be competitive and to insist on fair and equal treatment for U.S. manufacturers as well as our trading partners. The former purpose can be signally achieved by making Eximbank an effective and competitive vehicle for export finance -- which it is not at present. The latter especially relates to more vigorous enforcement of U.S. trade laws, as has long been advocated by NAM.
- Finally, the U.S. must take the steps in our internal economy that truly make a country competitive -- adopt measures in the field of taxation, R and D, education, fair trade and competition laws -- all in the context of a U.S. that must live and prosper in a world competitive environment. The Young Commission on Industrial Competitiveness has identified the major areas requiring attention.

In closing Mr. Chairman, I want to state that I can think of no more timely or appropriate subject for Congress to review at present than our trade deficit and the implications for U.S. competitiveness. We are at an economic crossroads. We must bring under control the massive twin deficits -- the trade deficit and the federal budget deficit -- which continue to bedevil our economy. Otherwise, continued recovery in the U.S. domestic economic growth will prove to be unsustainable, with resultant bad news for the world economy.

EXHIBIT 1

CHART 1: Trade Balances in Manufactured Goods

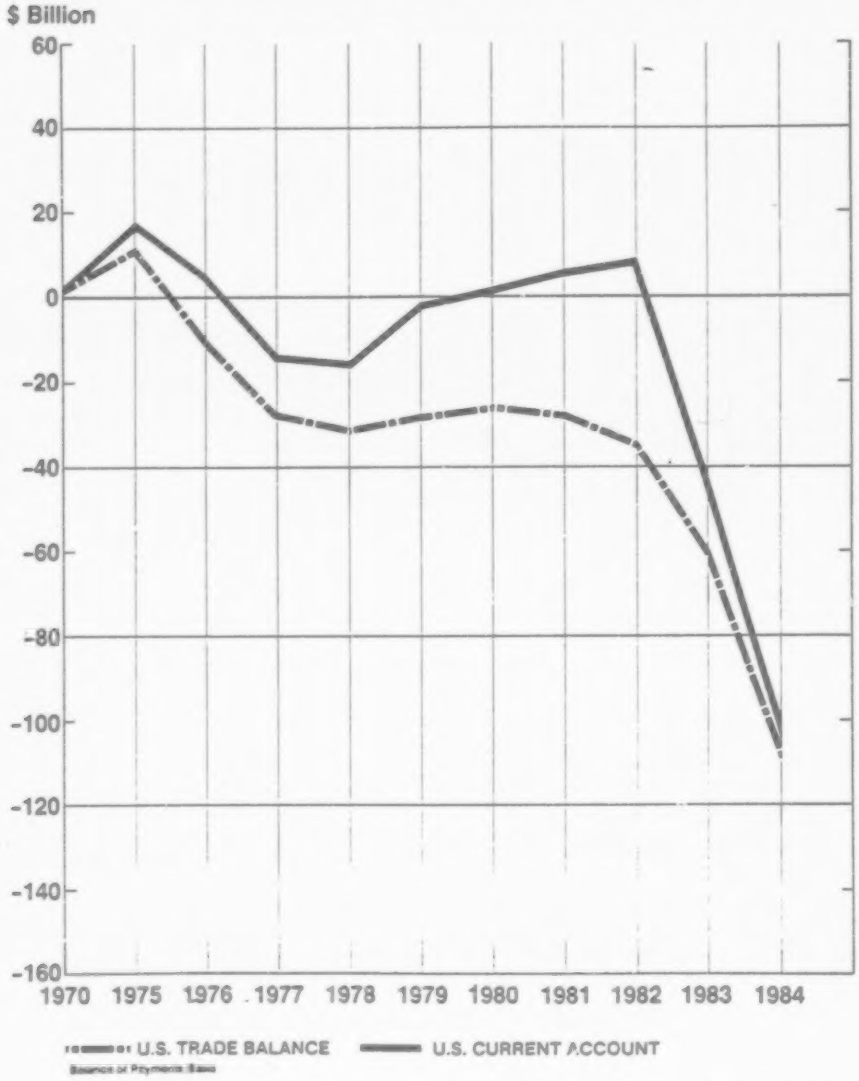


Japan and Germany: January–June 1984 at annual rate.

PREPARED BY THE NATIONAL ASSOCIATION
OF MANUFACTURERS 4/10/85

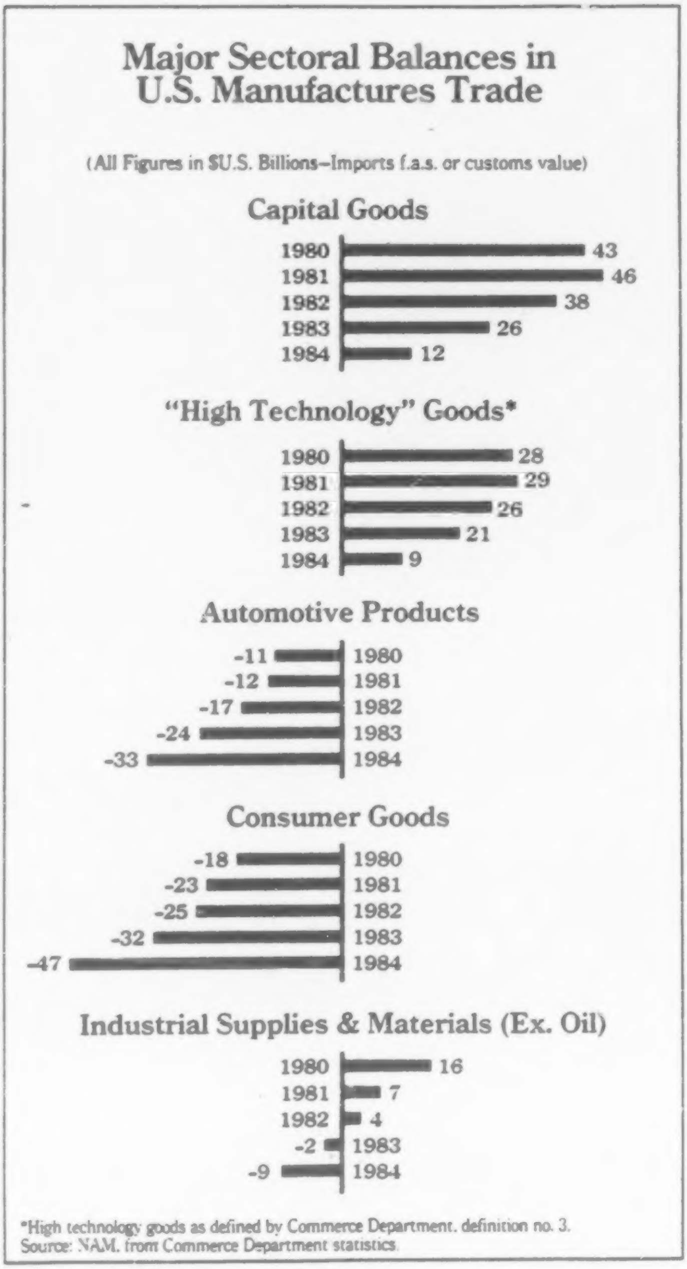
EXHIBIT 2

CHART 2: U.S. Trade Balance and U.S. Balance of Payments on Current Account



PREPARED BY THE NATIONAL ASSOCIATION OF MANUFACTURERS
4/10/85

EXHIBIT 3

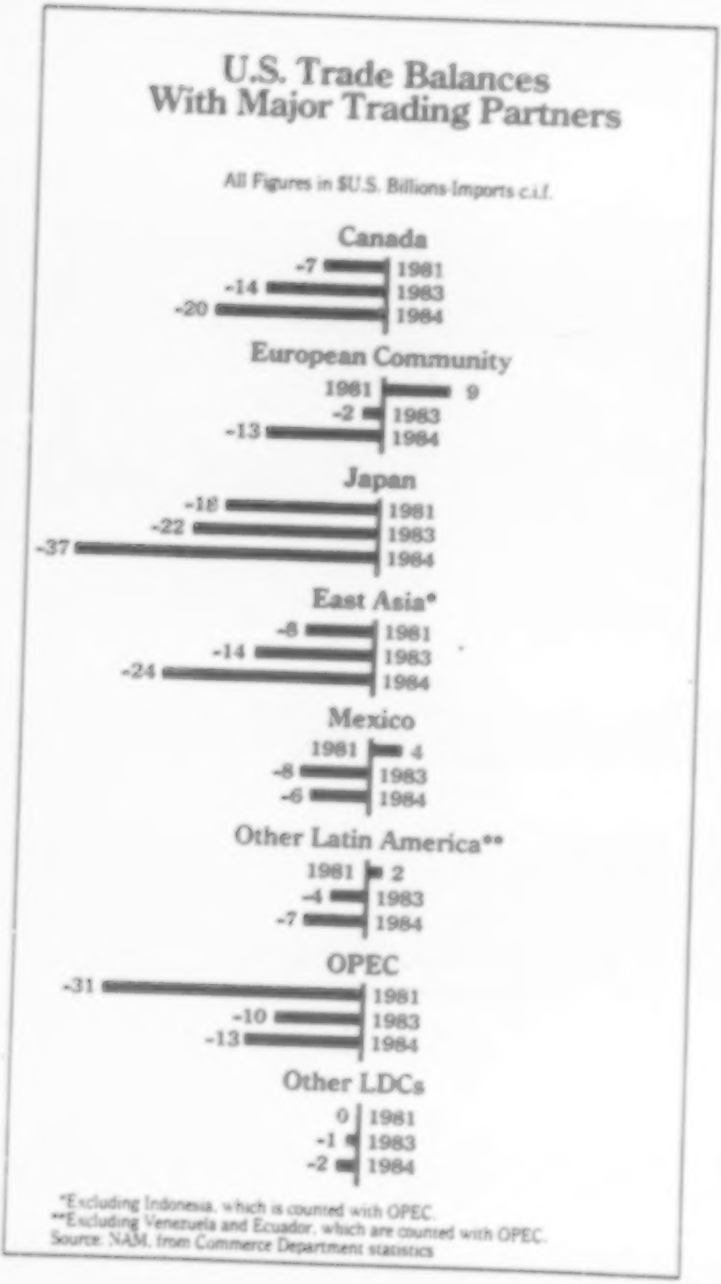


Major Sectoral Balances in U.S. Manufactures Trade

(All Figures in $U.S. Billions–Imports f.a.s. or customs value)

*High technology goods as defined by Commerce Department, definition no. 3.
Source: NAM, from Commerce Department statistics.

EXHIBIT 4



U.S. Trade Balances With Major Trading Partners

All Figures in $U.S. Billions-Imports c.i.f.

*Excluding Indonesia, which is counted with OPEC.
**Excluding Venezuela and Ecuador, which are counted with OPEC.
Source: NAM, from Commerce Department statistics

EXHIBIT 5

NAM

ADOPTED BY NAM BOARD OF DIRECTORS
FEBRUARY 10, 1984

RESOLUTION ON THE EXCHANGE RATE FOR THE U.S. DOLLAR

Whereas a competitive U.S. industrial base is possible only if the exchange rate for the dollar is realistic relative to the currencies of other major trading countries;

Whereas exchange rate policy must be developed within the context of national economic policy, and macroeconomic policies must be shaped with due regard for direct and indirect impact on exchange rates and trade;

Whereas the substantial rise in the value of the dollar against the yen, the deutsche mark and other major industrial country currencies in recent years has more than offset the reduction in the U.S. inflation rate and efforts to improve industrial productivity, thus making American-produced goods less competitive in both domestic and world markets;

Whereas the reduction in U.S. price and cost competitiveness due to exchange rate changes alone has been calculated as costing more than one million jobs in the domestic U.S. economy and has contributed significantly to the 1983 record U.S. trade deficit of $70 billion;

Whereas the effects of the dollar exchange rate misalignment are most serious respecting the yen and the deutsche mark, the currencies of our principal industrial competitors, and have contributed to their very large manufactured goods trade surpluses, as well as to the huge and growing U.S. trade deficit;

Whereas the deterioration of the U.S. trade and current account balances since 1980 has not led to a counter-balancing reduction in the exchange value of the dollar, but rather the dollar has maintained its value or even strengthened significantly against all major foreign currencies;

THEREFORE BE IT RESOLVED that the National Association of Manufacturers recommends that the U.S. develop fiscal and monetary policies designed to achieve progressive elimination of the federal budget deficit and reduction of high U.S. interest rates, and thereby help the dollar reach and maintain an exchange rate appropriate to the U.S. competitive position, while achieving major domestic macroeconomic goals.

BE IT FURTHER RESOLVED that the National Association of Manufacturers urges the development of an explicit U.S. exchange rate policy supportive of U.S. trade performance. Such an exchange rate policy should include:

- Improved coordination and consultation with other countries regarding the international effects of domestic economic policy, with the purpose of reducing dollar exchange rate misalignment, in accordance with agreements reached at the 1983 Williamsburg economic summit;
- Improvement of the present exchange rate system through the introduction of a greater degree of structure, the purpose being to reduce the present dollar misalignment without excessive levels of government intervention in currency markets;

(OVER)

- Special attention to the international position of the Japanese yen, to encourage its greater use as an international transaction and reserve currency, and thereby to encourage greater international demand for the yen relative to the dollar — thus raising its value. The recent agreement of President Reagan and Prime Minister Nakasone is an important step in the right direction and should be fully implemented as soon as possible.

In addition, the U.S. should take the lead in seeking long-term improvement in the international exchange rate system. Consultations with Germany, Japan, other major industrial countries and the IMF to reform the present system should be undertaken, so that it can better achieve the original objective of facilitating trade and investment by reflecting changes in economic fundamentals which determine competitiveness.

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EXHIBIT 6

NAM

APRIL 10, 1985

NAM Statement on U.S. Dollar Exchange Rate

On February 10, 1984, the NAM Board of Directors unanimously adopted a resolution on the dollar exchange rate and U.S. competitiveness. This resolution emphasized the negative impact of the rising dollar on the U.S. trade and current account balances, the U.S. industrial base, and the structure of the U.S. economy. Corrective policy actions by the U.S. government were recommended.

Over the past year there has been further deterioration in this situation. According to the 1985 Economic Report of the President's Council of Economic Advisors, by the end of 1984 the U.S. dollar exchange rate, as measured against a weighted basket of industrial country currencies, was 65 percent higher than in 1980. This was the highest exchange value that the dollar had reached since flexible exchange rates were introduced in 1973. At the same time, the U.S. merchandise trade deficit has dramatically worsened to almost $125 billion in 1984, and it is universally accepted that the persistent strengthening of the dollar is the major cause. The trade balance in manufactured goods deteriorated by about $50 billion in 1984.

Furthermore, the Department of Commerce has just reported that the overall deficit in the balance of payments on current account for 1984 had grown by over $60 billion last year, to $102 billion. Unlike the 1970s and the early 1980s, our growing trade deficit is no longer offset by increased net earnings in the other international transactions, such as private sector earnings on investments and the sale of services. Virtually all of 1984's trade deficit has been financed by an increase in the net public and private indebtedness of the United States to foreigners. This indebtedness and related interest payments will ultimately have to be serviced or repaid through increased current account earnings -- that is, through improved U.S. trade performance.

Recently the State Department requested comments from NAM regarding the continued high value of the dollar and the policy changes which might be necessary to make the dollar more reflective of the international competitive position of U.S. industry. This request was related to planning for the forthcoming Economic Summit. Unfortunately, relatively little of the program recommended by NAM's Board last year has been implemented. Our response to the State Depatment and this statement, therefore, focus on how the steps recommended last year might be updated and implemented to provide a program that the U.S. government should carry to the Bonn summit in May.

A combination of several different factors have caused the high dollar. These factors are well known and have been widely discussed, but they have changed in relative weight during the past four and one-half years of the high dollar. While the rise of the dollar actually began in an environment of relatively poor U.S. economic growth, followed by a deep recession, there is now a worldwide perception of the strength of the U.S. economy and the relatively poorer economic performance of most the rest of the world. High real interest rates in the U.S. relative to other countries have obviously been very important in attracting capital inflows, regardless of the weight one gives the federal budget deficit as a major cause of high interest rates. Naturally, no one wants to cure the dollar exchange rate problem by inducing inflation at home or a recession in the domestic economy. The problem of continued dependence of foreign economic recovery on ever greater exports to the U.S. market, with the resultant large and still growing U.S. trade and current account deficits, is an issue which should be discussed at the Economic Summit.

Therefore, the Economic Summit should address the dollar exchange rate problem, as well as the necessary steps to begin to put into place an improved exchange rate system that will more realistically represent U.S. trade considerations. The following are the essential steps needed to deal with the problem:

1. Significantly reduce the U.S. federal budget deficit. There is a possibility, of course, that the dollar might temporarily rise even further if we achieve action on the deficit. This risk is offset by the obvious benefits of deficit reduction. It will be very difficult or perhaps impossible to establish a general pattern of growth worldwide and lower interest rates unless the U.S. budget deficit is reduced.

2. Encourage policies conducive to sustained growth in Europe and the less-developed countries, especially Latin America, which are historically among our leading export markets.

3. Speed up the internationalization of the yen. The U.S.-Japan financial agreement of May 1984 provides the basis for more decisive action by Japan. Especially needed is prompt action to free up domestic financial markets in Japan. The Japanese government should also create the necessary financial instruments (e.g. Treasury bills) so that foreigners can use Japanese financial markets as freely as Japan uses the financial markets in New York, London, Frankfurt and Zurich.

4. Take steps to decrease worldwide use of the dollar as a "convenience" transaction currency, not by restrictive measures but by positive encouragement to use the yen, mark and other currencies more extensively in commercial transactions and central bank reserves. For example, it may be possible and desirable for the European Community to reduce use of the dollar in transactions related to managing their currency "snake."

5. The Treasury should explore, in consultation with other countries, the possible advantages of issuing U.S. federal debt issues in currencies other than dollars.

6. Take concrete steps in cooperation with the other major industrial countries to improve the operation of the present floating exchange rate non-system. In effect, this was agreed at Williamsburg in 1983 and expressed again in the January 17, 1985 "G-5" statement, but U.S. cooperation and participation has been sporadic at best. A more substantial commitment would require that the U.S. establish a stock of foreign currencies, which could be based on existing swap agreements.

   The purpose is not to overwhelm the markets, but to play a strategic game in cooperation with other countries. Currency markets should know that the U.S. has an "official view," even if unstated, as to the value of its currency, and an exchange rate policy to back this up. Regarding the view that currency markets are too big to be influenced without massive intervention, it has recently been estimated that true long-term flows on exchange markets are less than $500 million per day. This means that calculated, coordinated moves by central banks may have much more impact than commonly believed.

7. The best approach to the previous step is to begin with the objective of capping the dollar. This could best be done in conjunction with achievement of a successful U.S. budget deficit cut of $50-60 billion, but technical work should be started by central banks without delay. Possibly, we should avoid announcements of currency actions, to lessen the risk of excessive expectations or early failures.

   Currency markets have to be convinced that the U.S. has made a major policy decision to assert the importance of its national interest in trade in manufactured goods, agricultural products, coal and other minerals. The world trade community will see U.S. action as a means to help stop the spread of protectionism and to move toward more open international markets for goods and services.

8. Start consultations leading toward longer term reform of the floating exchange rate system. An appropriate technical forum, such as the IMF's C-20, G-5 or the Bank for International Settlements in Basel might be chosen. This longer term effort will help reinforce the short-term efforts described above. It will give credence to the view that the U.S. is serious about adding exchange rate policy to fiscal policy and monetary policy as macro-policy elements.

   As we begin such discussions, we should not be too dogmatic about what conclusions we will reach, although any consideration of a return to fixed exchange rates or generalized capital controls should be discounted from the outset. These consultations should be guided by our continuing short-term experience in capping the dollar. Above all, the U.S. must work in cooperation with the other major actors in the international financial system, whose fundamental interests in a sound international exchange rate system are not different from our own.

9. The program outlined above will help do one more thing: it will prolong the U.S. economic recovery by helping to convince the world that the U.S. means to deal with its $100 billion current account deficit and its consequent status as the country with the fastest and most significant increase in foreign debt. The sooner we do this, the more likely the Europeans as well as others will begin to take responsibility for promoting their own growth by means other than exports to the U.S. market and to former U.S. markets, where their products are now unduly competitive because of the high dollar. This is another important message for the Bonn Summit.

TRADE & INDUSTRY

NAM

January 18, 1985

Volume III, Number 1

U.S. Competitiveness and the Trade Deficit

The annual rate of the 1984 trade deficit through October was nearly $130 billion (imports counted c.i.f.—the most commonly used method). This is nearly double the deficit recorded in 1983. All of the change has been accounted for by an increase in the manufactured goods deficit, from $39 billion in 1983 to an annual rate of $92 billion in 1984. As recently as 1981, the U.S. actually recorded a surplus in manufactured goods trade.

This dramatic worsening in the manufactured goods balance, even though accompanied in 1984 by a small overall increase in U.S. exports of manufactured goods, exemplifies the decline in U.S. industrial competitiveness. This decline is inexorably linked to the rise in recent years of the dollar exchange rate, because the high dollar has created a price competitiveness problem for U.S. producers of internationally traded goods.

It has been argued that there is really no fundamental problem with overall U.S. industrial competitiveness. The trade deficit is a problem caused by a "temporary" upsurge in the exchange value of the dollar, combined with a boom in U.S. demand and lower growth or recession abroad. The only serious problems of U.S. competitiveness in this view are in certain traditional "smokestack" industrial sectors, where the U.S. has clearly lost its comparative advantage. Or, as argued in the 1984 New York Stock Exchange report on trade and the economy, even if U.S. industry is less competitive, plenty of jobs will be found in the rapidly growing services sector of the economy and in those industrial sectors most closely linked to services—particularly information services.

But the latest trade and GNP figures show a growing link between the U.S. trade balance, competitiveness and overall economic performance:

- Despite improved growth prospects worldwide, U.S. exports in 1984 did not rebound to any great extent. Meanwhile, manufactured imports increased at an astonishing 37 percent annual rate over 1983.
- The trade balance worsened as much in capital goods and "high technology" products, where the U.S. is assumed to be especially competitive, as in other areas.
- Foreign producers are gaining a much larger share of the U.S. capital goods market, indicating that a large part of the "accelerator" effect of the 1983-84 economic boom may take place abroad. This implies lower levels of domestic economic growth, not only in the short term but also for the remainder of the 1980s.
- In terms of regional distribution, the principal source of the increased trade deficit is trade with countries that primarily export manufactured goods: Japan, the other countries of the Far East and Europe. In 1984, adverse swings in the U.S. trade balance with Japan, the Far East and the European Community accounted for more than two-thirds of the increase in the total trade deficit.

Export and Import Performance

U.S. manufactured exports have ended two straight years of decline, but this performance has been far overshadowed by the continuation of rapid import growth. U.S. manufactured exports through October 1984 increased at a modest 8 percent annual rate, though even this was better than agricultural exports, which remained stagnant for the third straight year. Manufactured exports were still about $20 billion less than in 1981 despite improving economic performance in most foreign markets. But while the current dollar value of manufactured exports increased from $132 billion in 1983 to about $142 billion in 1984, imports (c.i.f. value) zoomed upward from $171 billion to an annual rate of $235 billion. As the trade deficit worsened in the latter part of the year, a $100 billion deficit **in manufactured goods alone** appeared entirely possible for 1984.

Capital Goods and "Hi-Tech" Trade

In terms of performance by major sectors, the most notable feature in U.S. manufactures trade was the rise of both absolute levels of imports and of import penetra-

continued on page 2

Hard Bargaining Ahead

It may be true that in the post-World War II era both the Washington policy machine and foreign trading partners have looked to U.S. administrations to set the international trade policy agenda. Remarks by Deputy U.S. Trade Representative, Ambassador Michael Smith, the head of the European Community's Washington delegation, Sir Roy Denman, and the international trade counsel to the Senate Finance Committee, Leonard Santos, made at the Dec. 6, 1984, NAM International Trade Policy Committee meeting, suggest this will be even more the case in the coming year.

U.S. Negotiating Objectives

Smith, who described 1985 as "a year of decision," talked about U.S. negotiating objectives in the GATT, the Geneva-based organization that has grown up around the General Agreement on Tariffs and Trade, and in other fora. He highlighted four "new" areas in which current international disciplines are inadequate to deal with the realities of trade:

- services,
- protection of intellectual property rights, including patents, copyrights and other forms of intellectual property,
- trade in high technology goods, and
- the relationship between trade and

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National Association of Manufacturers • 1776 F Street, NW • Washington, DC 20006 • (202) 626-3700

tion in capital goods and high-technology products. Figure 1 shows that U.S. surpluses in capital goods and high-technology products—once the core of U.S. trade performance—have all but disappeared. As a consequence, trade in these areas no longer offsets the large deficits in automotive and consumer goods. At an annual rate of $11 billion (imports at customs value), the capital goods surplus is only about one-quarter of the 1981 level and less than half the level of 1983. Similarly, the surplus in all types of hi-tech goods—down to only $5 billion in 1984—is one-fifth of the 1981 level. Meanwhile, U.S. deficits continue to increase dramatically in the other major sectors—by 50 percent in the last year alone in consumer goods, to $48 billion, and by 33 percent in automotive goods to $33 billion, despite continuation of the quota on Japanese imports.

Figure 2 indicates how these developments in capital goods trade are beginning to reshape the entire economy. The Machinery and Allied Products Institute's *Capital Goods Review* recently reported that, on a real basis, the U.S. has now become a net capital goods importer. This is reflected in Figure 2, which shows that for the first three quarters of 1984 real imports equalled 25 percent of total U.S. capital goods consumption, defined here as real non-automotive private purchases of durable equipment (PDE). Real exports equalled only 23 percent of capital goods consumption.

Figure 2 also indicates that this change reflects less U.S. competitiveness, not just the natural consequences of increased world trade. Between 1970 and 1980, imports expanded rapidly, from 9 percent to 15 percent of capital goods consumption. But exports grew by a similar amount, from 28 percent to 34 percent. This reflected both foreign technological "catch up" and an expanding world trade economy in which aggressive U.S. exporters became more oriented toward faster-growing foreign markets. In the 1980s, U.S. imports have accelerated to reach a level equal to one-fourth of consumption, as shown in Figure 2. But the level of exports has tumbled from more than a third to less than a quarter of domestic consumption as exports have been discouraged by both uncompetitive dollar prices and slower foreign growth.

Similarly, analysis on a more detailed product basis reveals that the United States is troubled not only in areas that have been suffering long term decline, but also in areas where it is most competitive. However, because both exports and

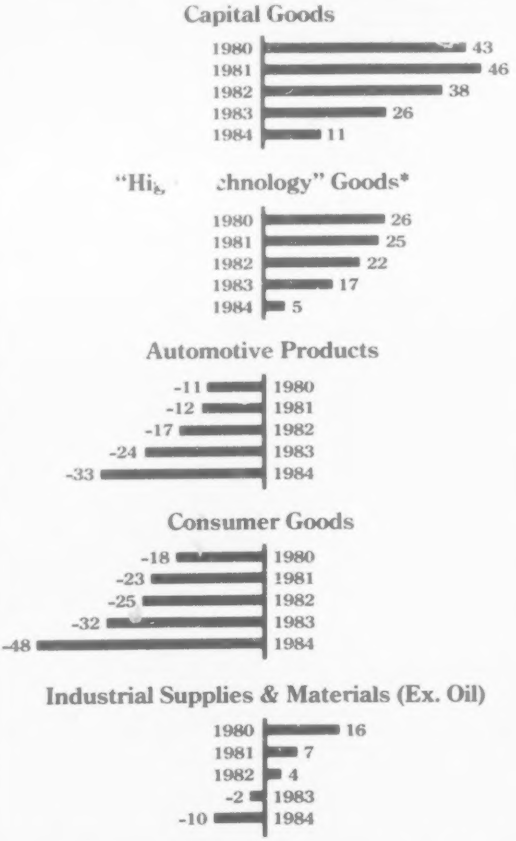
continued on page 3

Figure 1

Major Sectoral Balances in U.S. Manufactures Trade

(Jan.-Oct. 1984, Annual Rate)

(All Figures in $U.S. Billions–Imports f.a.s. or customs value)



*High technology goods as defined by Commerce Department, definition no. 3. Imports c.i.f.
Source: NAM, from Commerce Department statistics.

domestic sales of these products have been on the rise, the growth of imports in the domestic economy does not receive as much attention as do cars, textiles and apparel, footwear or steel. A good example is non-consumer communications equipment and electronic components—the largest category, in terms of trade, on the Commerce Department's hi-tech list. Between 1980 and 1984, exports increased in value by 40 percent from $9.9 billion to $14.1 billion, but imports more than doubled from $11.9 billion to $28.1 billion. A small deficit of $2 billion thus grew to $14 billion. Meanwhile, exports of office, computing and accounting machines increased by an even larger amount from $8.7 billion to $14.4 billion, but imports jumped fourfold—$2.6 billion to $10.5 billion. And the U.S. trade surplus fell by a third, from over $6 billion to under $4 billion. Such developments in highly competitive U.S. product lines have great significance for domestic economic growth in the long term.

Effect On Domestic Economy

It is now widely conceded that the trade deficit—as it influences the "net exports" item in the GNP—may be largely responsible for the abrupt fall in the U.S. growth rate in mid-1984. Economist Alan Greenspan has calculated that with no change in net exports, the increase in growth in the third quarter of 1984 would have been three times as high as actually occurred—5.7 percent instead of 1.9 percent.

Nor is this situation limited to the short term. Recent changes in trade patterns have accelerated the impact of negative long-term competitiveness trends. For example, though the administration boasts of 6 million jobs created during the present period of recovery and growth, these jobs are all in services—manufacturing employment is actually still lower than in 1981. Unlike the 1960s and 1970s, the 1980s has seen rapid import growth at a cost to U.S. jobs and production in industries across the board without an expansion of export opportunities. If continued, this may lead, not to a greater specialization of the U.S. industrial base, but to a substantial reduction of that base and possibly to an overall contraction of domestic growth.

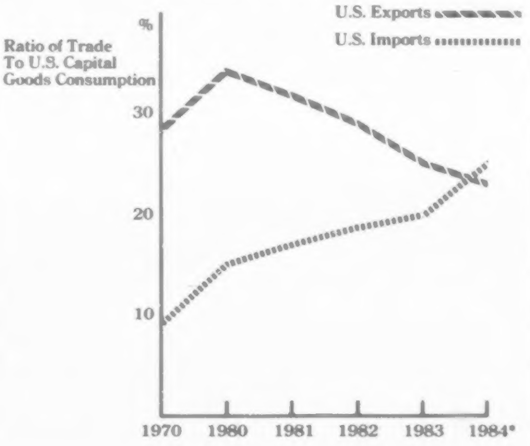
Regional Trade Balances

A look at the shifts in regional trade balances in Figure 3 shows that most of the rise in the U.S. trade deficit is due to worsening balances with the major developed country trade partners. Except in the case of Canada, the U.S. has seen rapidly increasing imports without similar export increases, even in those areas—namely, Japan and the Far East—where local economic growth has been strong.

Figure 2

Ratio of U.S. Exports and Imports of Capital Goods to Total Domestic Capital Goods Consumption

Capital Goods Consumption Defined As Private Purchases of Durable Equipment In National Income And Product Accounts—Excluding Automotive Products. Ratios Based on Real Values.



*-First Three Quarters

Source: NAM, from Commerce Department statistics.

Japan alone accounts for nearly a quarter of the change in the overall U.S. trade balance since 1981. The U.S. bilateral deficit has worsened by over $20 billion, with most of the change occurring in the past 12 months. Japanese exporters have realized a bonanza from the U.S. economic recovery, as Japanese exports to the U.S. jumped nearly $18 billion (41 percent) in 1984 alone. By contrast, U.S. exports to Japan increased by only $1.3 billion (less than 6 percent).

Figure 3 shows that the unfavorable swing in the U.S. trade balance was even more pronounced with the **European Community**. A 1981 surplus of $9 billion became a U.S. deficit of about $14 billion in 1984—a net $23 billion change. Here again, U.S. imports rose dramatically in the last year—by $16.6 billion or 31 percent. A stronger recovery in most of Europe's domestic economies, thanks partly to export sales to the U.S., allowed U.S. exports to the European Community area to increase by $2.5 billion (5.6 percent) in 1984, but U.S. exports were still $6 billion less than in 1981.

The manufactures-exporting **East Asian nations** (excluding OPEC member Indonesia) demonstrated a similar pattern in trade relations with the United States. Exports to the U.S. rose rapidly (36 percent) in the past year, while U.S. exports to that region increased by less than 5 percent. This contributed to a $17 billion worsening in the U.S. trade balance since 1981. Most of this change is due to U.S. imports from the so-called "four tigers," the newly industrializing countries of South Korea, Taiwan, Hong Kong and Singapore.

Canada provides a virtually isolated example of a major increase in U.S. exports (see also Mexico below). Still, increased U.S. exports of $9 billion (23

continued on page 4

percent) in 1984 were only two-thirds the level of increased imports from Canada of $14 billion (up 26 percent). Since 1981, the overall U.S. deficit with Canada has worsened by a total of $13 billion. As shown in Figure 3, the overall U.S. deficit with Canada has increased as steadily as that with other regions. It is possible that only special features of the U.S.-Canada relationship have prevented this worsening from being more evident in 1984. By contrast to its performance against other currencies, the U.S. dollar has not moved upward by very much against the Canadian dollar over the last two years. Also, the auto agreement bolsters U.S. exports to Canada when the U.S. auto market booms—and these "exports" are reimported as components of Canadian-made, U.S. brand vehicles.

Surprisingly, if we exclude the Far East NICs, there has been relatively little overall deterioration in the U.S. trade balance with the less-developed countries since 1981. This is a somewhat misleading statement in that U.S. trade balances with Mexico and other Latin American countries have markedly worsened, but this has been largely offset by improvement of the trade balance with the OPEC countries.

In the cases of **Mexico and Latin America** the main feature has been falling U.S. exports, not rising imports. U.S. exports to Mexico were halved, from $18 billion to $9 billion in 1981-83, but rebounded sharply in 1984 (up at an annual rate of $2.7 billion or 30 percent). In the rest of Latin America (excluding OPEC members Venezuela and Ecuador), U.S. exports fell by 50 percent, from $15 billion in 1981 to $10 billion in 1983, and in these countries there was no recovery in 1984. The increase in imports from Latin America has been negligible by comparison with the increase in imports from the industrial countries. U.S. imports from Mexico increased at an annual rate of only 8.2 percent through October, an annual rate of $1.4 billion. For the rest of non-OPEC Latin America, U.S. imports increased at a much higher percentage rate (29 percent), but this equalled an annual dollar total of only $4 billion.

The non-OPEC developing countries outside Latin America have contributed only marginally to the expansion of the overall U.S. trade deficit. As shown in Figure 3, the total U.S. deficit with all these countries has worsened by just $2 billion since 1981.

These adverse developments in U.S. trade with developing countries have been mostly offset by a a net $17 billion

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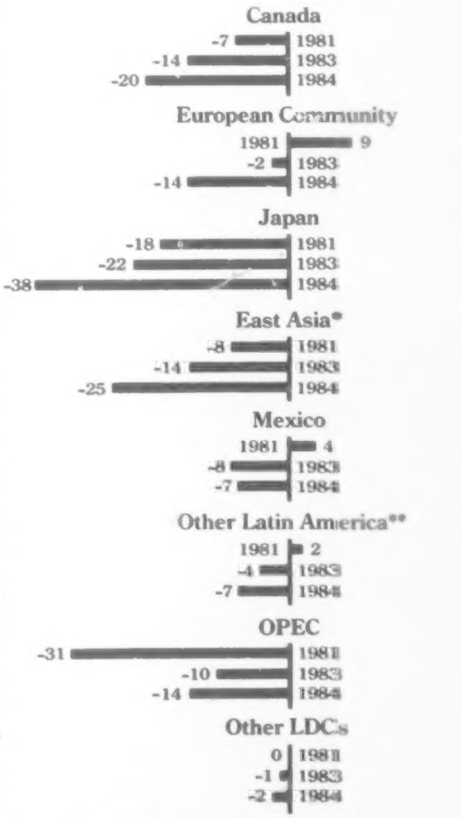
Figure 3

U.S. Trade Balances With Major Trading Partners

(Jan.-Oct. 1984, Annual Rate)

All Figures in $U.S. Billions-Imports c.i.f.



*Excluding Indonesia, which is counted with OPEC.
**Excluding Venezuela and Ecuador, which are counted with OPEC.
Source: NAM, from Commerce Department statistics

U.S. Competitiveness *continued*

improvement in the U.S. balance with **OPEC** since 1981. However, as Figure 3 shows, the gains made in 1981-83 have been eroded in 1984. This is due to both falling U.S. exports to OPEC and rising U.S. imports. U.S. exports to OPEC did not peak until 1982, when they reached nearly $25 billion. U.S. exports fell to $17 billion in 1983, and have fallen further to an annual rate of $14 billion in 1984. Meanwhile, annual U.S. imports, which fell by $25 billion between 1981 and 1983, to just $26.5 billion, increased by an annual rate of about $2 billion through October 1984. The worsening balance with OPEC will thus actually contribute $4.5 billion to the 1984 increase in the trade deficit. Again, this is relatively insignificant compared to the worsening of the deficits with the industrial countries.

To summarize these regional numbers, it appears that the U.S. trade problem is actually worst with our major country partners—a further indication of falling competitiveness as U.S. imports surge from these countries. The net decline in the trade balance with developing countries has been far less. Substantial declines in U.S. exports have been offset by a drop in oil imports and less impressive growth of U.S. non-oil imports from the LDCs. U.S. trade performance with the LDCs, however, does add to the overall trade problem since the strong dollar, weak local export earnings and continued weak domestic demand due to the debt crises have largely dried up these markets as alternatives to industrial country markets for U.S. products.

Trade & Industry

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Hard Bargaining *continued*

investment, including trade-related investment performance requirements. The U.S. government would like to see negotiations in each of these areas, Smith said.

He explained that GATT working parties have been set up in the first two—services and intellectual property rights. The reports of these groups are due by the end of this year. If things move smoothly, these issues should be ripe for discussion in the context of a new GATT round, which could begin as early as 1986. In his comments on services, Smith noted that, although services accounted for less than 5 percent of U.S. trade in 1947, they represented "better than 40 percent of U.S. trade," in 1982. The GATT must address the service industry issues, he said, if it is to remain the principal international trade organization.

Unfortunately, the GATT has not really begun to work on either of the last two new issues Smith identified—trade in high technology goods and investment policies that affect trade. Smith said "there is a great deal of controversy" over the investment issues and the proposal to take them up in the GATT. There is a conflict between each nation's desire to preserve its sovereign freedom of action vis-a-vis investment policies and the need of the international trade community as a whole to curb the trade-distorting effects of those policies. That conflict will not be easily resolved.

How Many To Tango

Ambassador Smith's remarks and those of Sir Roy Denman were mutually reinforcing to a point and then diverged. "We have tried to make it clear internationally," Smith said, "that we still fervently believe in the multinational system." In his view, however, it does not necessarily follow that all negotiations—whether on the new issues or on old ones like agriculture, subsidies, and market access—need to be in the GATT. He pointed out that the GATT has changed dramatically since the General Agreement began to function as the basic law of international trade. There were only 26 members in 1947, Smith said. Now there are 91. One of the ramifications of this increase is that the wishes of countries accounting for most of world trade are no longer necessarily the will of the GATT. Smith said that the European Community, the United States, the EFTA countries (Austria, Iceland, Norway, Portugal, Sweden, Switzerland, and associate member Finland), Australia and New Zealand all favor a new round of GATT negotiations. The last such round was the Tokyo round, completed in 1979.

But, said Smith, the majority of GATT members do not favor a new round, "or at least are not willing to say so publicly." He said that under the circumstances, the United States is willing to explore new agreements with interested trading partners on a plurilateral basis—negotiations involving several trading partners but less than the full GATT membership—or on a bilateral basis. In any event, the U.S. objective would be to take any agreements reached outside the GATT and, ultimately, fold them into the multilateral system. "What we are trying to do," he said, "is to get negotiations going."

Denman, who early in his remarks offered the aside that "there is no such thing as free trade," put the first accent of his talk on the need to maintain what he called "the one world trading system." He was, however, considerably less sanguine than Smith about the compatibility of that objective and negotiations outside the GATT, such as bilateral negotiations between the United States and others.

As Seen by Senate Staff

Leonard Santos agreed with Sir Roy Denman's prediction that 1985 and 1986 would be difficult years for trade. Referring to the recovery of 1983 and 1984, Santos said, "'85 and '86 will bring different numbers. And with those numbers the impact of the trade deficit will bring Congressional reaction." That was not necessarily a prediction for significant new trade legislation, as Santos made clear. "Unless it [the administration] has something that it wants to enact, there is really no engine for trade legislation," he said.

That hardly means the congressional trade committees will be idle. Santos reminded his NAM audience that the Senate Finance Committee will have a new chairman, Sen. Robert Packwood (R-OR) succeeding Sen. Robert Dole (R-KS). He described Packwood as a senator "committed to an open trading system."

Among the issues the Finance Committee is likely to take up in 1935, Santos said, are—

- a free trade agreement with Israel when the agreement authorized by the Trade And Tariff Act of 1984 is submitted to Congress;
- Japan's restraint on automobile exports to the United States, which will expire at the end of March if it is not renewed;
- Sen. John Danforth's (R-MO) Telecommunications Trade Act;
- the possible creation of a new trade department; and
- legislation to amend U.S. countervailing duty law so that imports benefitting

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Hard Bargaining *continued*

from certain natural resource inputs in the country of origin can be regarded as subsidized under U.S. law. Sen. Russell Long (D-LA) is expected to offer legislation in this area (see November 23, 1984 *Trade & Industry*).

Santos also talked about the major trade bill of the last Congress, the Trade and Tariff Act of 1984. He said although the bill was not intended as a program for dealing with the trade deficit, it is nevertheless surprising that it turned out to be as liberal a document as it is in view of the skyrocketing trade deficit, estimated at nearly $130 billion for 1984. In this connection, Santos mentioned both the 8½-year renewal of the GSP program granting duty-free treatment to imports from less developed countries, and the authorization for a free-trade agreement with Israel. The latter, Santos said, is important not simply in its own terms but because the agreement with Israel is likely to prove a model for bilateral agreements with other countries.

Santos advised those interested in the mood of Congress to look to the "reciprocity" section of the new trade bill. It sets the tone for the law, he said, adding that it is the time for a reciprocal approach to the trading system. What has changed is not the word but its meaning. From the enactment of the Reciprocal Trade Agreement Act of 1934 until the debate on Senator Danforth's reciprocity bill came to full flower, reciprocity has referred to a balanced system of concessions. As a result of the Trade And Tariff Act, it now refers to the principle of equivalent market access.

As to the GATT, Santos reported it "alive if not well" in Congress. It is remarkable, he said, that a document often regarded as remote or irrelevant exerts as much influence as it does in the deliberations of Congress. But there are clouds on the horizon. Santos described the tension between the economic, free-trade, consumer oriented philosophy that is the underpinning of the GATT on the one hand and the political convictions of many members of Congress on the other. To those whom Santos described as economic philosophers, the trade deficit is not necessarily a bad thing. To senators and congressmen, he said, it is.

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Confident Canada Looks At Trade Options

Today's Canada is a more confident country than the Canada of a decade or so ago. That observation was at the heart of a talk given by Jacques Roy, economic minister and deputy chief of mission at the Canadian embassy in Washington, on Dec. 6, 1984. In his remarks to the fall meeting of NAM's two international committees, Roy noted that, despite her long history, Canada has only recently acquired some of the trappings of nationhood such as a flag, a national anthem and a constitution that is more clearly Canadian. "Repatriated" was Roy's word for the 1982 changes to the British North America Act of 1867; changes that transformed the formal character of that document from British to Canadian while retaining most of its essential features.

On a more substantive level, Roy cited the fact that the debate over the future of Quebec is now history and said that confidence is high in all of the provinces, from the Maritimes to British Columbia. While he did not claim that all of this happened on September 4, when the new Conservative government was voted into office, Roy did make some connections. He noted, for example, that the Mulroney government includes representatives from each of the provinces, giving it "an imposing national mandate."

Trade Options

A Canadian government proposal to enhance the trade relationship with the United States is still weeks or perhaps months away, but there have been plenty of indications already that this is a high priority for the Mulroney government (See December 28 *Trade & Industry*). Roy reinforced this and described three options now being considered as frameworks for U.S.-Canadian trade negotiations:

- a functional structure in which the two sides work toward improvements with respect to classes of impediments such as buy-national or buy-local laws that act as non-tariff barriers to U.S. products in Canada and Canadian products here;
- a trade enhancement agreement aimed at improving trade and investment opportunities for U.S. and Canadian nationals in both countries; and
- a comprehensive free trade agreement.

Roy said that the last option was previously rejected in Canada because it was seen as a threat to Canadian sovereignty. "But," he said, "Canada has become a more confident country, and it is now possible to look at that option."

Notwithstanding Canada's projected 1984 trade surplus with the United States of nearly $20 billion, Canadians are a little uneasy about the trade relationship. Roy said that the Canadian embassy in Washington has more economic/commercial officers than any other Canadian embassy in the world, 26 in all. The intention had been that most of these individuals would devote their time to trade promotion, helping Canadian firms find U.S. buyers and otherwise learn their way around the U.S. market. But circumstances have dictated otherwise, and 24 of the 26 officers spend 90 percent of their time working on what Roy called "trade defense." Elaborating, he said the Canadian embassy here is caught up in the task of getting U.S. officials to realize that "actions you [the United States] are taking should not affect Canada because we have a very special trade relationship."

However reasonable that proposition is, it is at least different from, if not at odds with, the most favored nation (MFN) principle, which is supposed to guide all countries adhering to the General Agreement on Tariffs and Trade (GATT). In essence, this principle says that all foreign suppliers should be accorded equal treatment in the markets of their GATT trading partners. Arguably, Roy was describing a Canadian objective as the starting point for a discussion. In that sense, his luncheon talk was a model of good negotiating and good diplomacy, made more so by the wit and humor with which the Canadian case was presented.

If, at the end of his remarks, anyone in the audience doubted that there is a reservoir of good will in Canada for the inhabitants of the 50 U.S. states, Roy offered reassurance. Quoting a Canadian politician of some time back, he said, "The United States is our best friend, whether we like it or not."

Surcharge Proposed

December 6—Motorola's president John Mitchell urged the NAM Trade Committee to look carefully at the potential value of a temporary import surcharge as a tool for dealing with America's trade deficit, its causes and consequences. In a well-prepared, sobering presentation, Mitchell set out for the members of NAM's international committees the consequences of doing nothing about the trade deficit, the budget deficit and the overvaluation of the dollar, and he discussed the contribution an import surcharge could make in each of these areas.

A working group of the NAM International Trade Policy Committee is being formed to evaluate the merits of an import surcharge and to consider whether

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Surcharge *continued*
NAM would support a proposal such as that advanced by John Mitchell.

The efforts of the working group are not likely to take place in isolation. The idea of an import surcharge is now raised with some regularity in discussions of trade policy. And Congress may take a long, hard look at the surcharge option in 1985.

In his talk, which was accompanied by a series of graphs and charts, Mitchell cited the factors that anyone evaluating a surcharge proposal will have to consider. First among these is the budget deficit; $175 billion in 1984 and growing rapidly. Mitchell said that estimates prepared by Data Resource, Inc. (DRI) showed the deficit climbing to around $400 billion by 1990. The hopes of the Reagan administration notwithstanding, few economists believe GNP growth alone will be enough to resolve the crisis, he said.

Mitchell acknowledged that Japan and Germany have run larger budget deficits as a proportion of GNP than the U.S. budget deficit. But those countries have high trade surpluses and higher savings rates, Mitchell said. Under the circumstances, the United States can take little comfort from the fact that the U.S. budget deficit is roughly 5 percent of GNP.

The second factor to consider is the U.S. trade deficit. Rather than offseting the budget deficit, U.S. merchandise trade has produced a deficit that is "the mirror image" of the budget deficit. In Mitchell's view, it is not at all reassuring that these deficits are being financed by an unprecedented influx of foreign capital. A high proportion of foreign investment in the United States, he pointed out, is in the form of U.S. Government securities and other short-term assets. His key point is that there is a heavy price to be paid for huge budget and trade deficits financed in this manner. And that price is paid by U.S. manufacturers. One example of this is the dramatic swing in the U.S. balance of trade in manufactured goods, which has gone from a surplus of $12.5 billion in 1980 to an estimated deficit of over $90 billion in 1984.

The crushing impact of the overvaluation of the dollar and the high cost of capital for U.S. companies, both of which are largely consequences of the budget deficit, have had their effects on corporate decisions. If corrective action is not taken, Mitchell said, more and more companies will shift production overseas and export to the United States. A pattern of decisions like these, taken as a matter of economic necessity for the firms involved, will render U.S. industry even less competitive than it is today.

The Proposal

The proposal was not described as the answer to the trade and budget deficits or to the overvaluation of the dollar, but as something that could offset some of their damage. The proposal assumes that other measures to reduce the budget deficit will be taken as well; that new spending cuts or tax increases will become effective as the surcharge is phased out. The temporary surcharge would be applied to all manufactured imports, including oil, for three years. In the first year, it would be 20 percent of the value of the imports; in the second year, 15 percent; and in the third year, 7 percent. Mitchell said that there would need to be some exceptions for imports from the less developed countries.

Section 122 of the Trade Act of 1974 provides authority for an import surcharge and other market restricting measures "to deal with large and serious United States balance of payments deficits" and for other reasons. That authority, however, is for a surcharge of no more than 15 percent to last for no more than 150 days. With the estimated 1984 balance of payments deficit running at over $100 billion, the first condition would appear to be met, but the scope of authority is far short of what will be necessary. Thus the proposal is for a change in the law, granting broader authority to the administration to take the action described.

Mitchell explained that Motorola had commissioned research on the question of whether a temporary surcharge like the one he is proposing would be permissable under the General Agreement on Tariffs and Trade (GATT). He said that, in the opinion of their lawyers, it would be. Undoubtedly that conclusion will be questioned in the months ahead, along with the assumption for the DRI model that our trading partners would not retaliate if a 20 percent surcharge were slapped on their exports to the United States.

Other arguments against the surcharge were squarely addressed and fairly handled. Although the surcharge would mean an immediate jump in inflation, this short-term disadvantage would be offset, he said, by—

- a counter-inflationary impact on prices as the surcharge is phased out;
- an immediate reduction in the current account deficit;
- a reduction in the trade deficit;
- more competition in the U.S. market from U.S. companies; and
- an effective reduction of foreign export prices.

Mitchell said the DRI estimates assumed that foreign exporters would absorb at least half the cost of the surcharge. In view of the fact that foreign exporters' U.S. prices have fallen only 10 percent during a period when the exchange rate value of the dollar has gone up 30 percent, this seems more than plausible. Foreign exporters are riding on a comfortable cushion of profit. It is unlikely that they would readily sacrifice market share to maintain profit margins that are, in effect, windfalls of the exchange rate misalignments.

Exchange Rate Effects

The effect on the exchange rate is perhaps the largest unknown in the surcharge equations. DRI's analysis did not show an early downturn in the value of the dollar but does suggest more realistic exchange rates over time.

The logic of the proposal is that a reduction in the budget deficit should ease the pressure on interest rates, cool the ardor of foreign investors for U.S. assets and, in time, curb the overvaluation of the dollar. The traditional view, however, is that a surcharge would raise the value of the dollar by cutting the demand for imports and reducing the supply of dollars in the hands of foreigners. As a scholar not in favor of the import surcharge pointed out, this is one instance where tradition and the record may diverge. According to Stephen Marris, a senior fellow at the Institute for International Economics and an expert on exchange rates, import surcharges have usually resulted in a further depreciation of the currency of the country imposing the surcharges.

The main precedents occurred, of course, under fixed exchange rates. The fact that surcharges preceded devaluations does not mean they caused them. Rather the record may simply reflect the inadequacy of the surcharge and other domestic economic measures to reverse the problems, the trade deficits, that gave rise to them.

Mitchell, too, made the point that a surcharge does not necessarily lead to a rise in the value of the currency, referring specifically to the surcharge imposed from August to December 1971. "I have a lot of trouble with people who say the exchange rate would stay up if the interest rates came down," Mitchell said, adding that that is not consistent with the logic that has been used to explain the serious exchange rate misalignments we now confront.

IEA Calendar

February 1
Meeting of the Working Group to Examine the Proposal for an Import Surcharge
9:30 a.m.-Noon
NAM Board Room

February 13
Meeting of the International Trade Policy Committee
9:30 a.m.-4:00 p.m.
NAM Board Room

Investment Committee Meets

The International Investment and Finance Committee met on December 6 in Washington as part of the NAM International Economic Affairs Committee program. Richard E. Heckert, vice chairman of DuPont and chairman of the committee, presided over the meeting. The committee focused on the role of exchange market intervention as an element in addressing the problem of the overvalued dollar, and in a closed session, discussed the issues of South Africa and OPIC reauthorization.

Intervention and the Dollar Exchange Rate

The opening session, on exchange rates, was chaired by David E. Bodner of Bank Julius Baer, who serves as chairman of NAM's International Finance Subcommittee. In his introductory remarks, Bodner stated that the "U.S. government should not ignore the exchange market," particularly since it is already "being managed directly and indirectly by governments—including the U.S. government." He expressed sympathy with the German government's view that the U.S. should have participated in recent currency market interventions to strengthen the mark in order to make Bundesbank actions more effective. Bodner also urged members of the committee and of the U.S. industrial community in general to more actively voice their views on exchange rate problems. U.S. companies, in Bodner's opinion, cannot afford to view the dollar exchange rate issue as one that is "too technical" for them to play an effective role.

Speaking on behalf of the U.S. government was Charles Dallara, who recently resigned as deputy assistant secretary of the Treasury for international affairs to become the U.S. executive director at the IMF. Dallara pointed out that the present administration has never abjured intervention in principle, but rather has limited the technique to use in disorderly market conditions. He noted exchange market intervention by the U.S. in September 1984 and a total commitment of over $600 million since late 1983. Dallara acknowledged, however, that the Treasury did not see such limited intervention as a major tool in achieving long-term stability in the exchange market. "The only course to lasting stability," he said, "is converging economic performance."

Elaborating on this point, Dallara emphasized that the 1976 revised IMF agreement placed the major responsibility for exchange-rate performance on the internal policies of member states. Domestic conditions for economic stability and growth were viewed as more significant than "external relations" in determining relative currency values. In this light, Dallara ascribed the strengthening of the dollar since 1980 to sharply improved relative U.S. economic performance, particularly with respect to the control of inflation and a more rapid recovery than other countries from the recent world-wide economic recession. He also cited more favorable prospects for long-term U.S. economic and political stability than for other areas of the world. But Dallara also expected the relative performance of other economies to improve significantly, given a recent trend toward "convergence" in policy approaches. This convergence involved increasing "multilateral surveilance"—not over exchange rates per se, but over domestic economic policy goals and performance.

Dr. Stephen Marris, formerly chief economic advisor to the OECD, now with the Institute for International Economics in Washington, also addressed this issue. In response to Dallara's remarks, Marris noted the relatively small scale of U.S. intervention in recent years, and suggested that convergence as a solution to exchange market problems would only work over the long term, if at all. Furthermore, Marris said that while governments might agree with the objectives of convergence, they are not likely to agree on the means to achieve those objectives. He noted particularly the recent divergence between British, French and German reduction of structural budget deficits as a share of GNP, and the substantial increase in the U.S. federal budget deficit.

In fact, Marris said, all central banks other than the U.S. Federal Reserve Board have pursued an exchange rate-dominated policy since the mid-1970s. This means, in effect, a policy of "unsterilized" intervention—allowing international currency market interventions to influence domestic money supply levels. It was this explicit acceptance of an exchange-rate goal as part of national monetary policy that has allowed the European Monetary System (EMS) to work reasonably well, keeping currency relationships relatively stable despite highly divergent political and economic conditions in member states. EMS was not intended to prevent any changes in exchange rates, but to allow orderly changes of parity that reflect changes in economic fundamentals. A further EMS objective is to provide some degree of international discipline over domestic economic policies. Under EMS, member countries are prepared to undertake exchange market interventions that are relatively much larger than those of the U.S. in recent years and to regard such currency intervention as normal. Such a system might work on a global scale, Marris said, but only if the U.S. government indicated that it too was committed to an effective strategy of exchange market intervention: it would have to indicate a willingness to undertake supportive changes in U.S. monetary and fiscal policies. Without such a policy change by the United States in the near future, Marris said, there would be a major, precipitous fall in the dollar within two years, which would bring with it massive currency intervention by the United States and other countries to avoid "a collapse of the dollar." Such a collapse would reflect a loss of confidence in the sustainability of those conditions of high domestic growth and low inflation that have supported a high dollar despite large trade and budget deficits.

Other Issues: South Africa And OPIC

The remainder of the meeting, which was closed to the press and other non-committee members, focused on the recent developments in South Africa and possible congressional legislation establishing economic sanctions.

Chairman Heckert opened this session with a brief statement that NAM, as well as its individual member companies, was totally opposed to any form of racial discrimination, particularly the South African system of apartheid. The judgment of those companies operating in South Africa was that the apartheid system could be changed more readily by the continued operation and influence of U.S. companies than by their withdrawal. This view was shared by the administration and articulated by Dr. Chester Crocker, assistant secretary of state for African affairs. He noted that substantial positive changes had been made in the South African regime with respect to both its domestic and international policies, and that both the business community and the administration had supported such changes. Referring to the present crisis, he said that both the U.S. government and the U.S. business community in South Africa have called for the release of the black labor leaders who had been detained.

Sal Marzullo of Mobil Corporation, who serves as chairman of the Industry Support Unit of the Sullivan Code organization, responded on behalf of U.S. business. Marzullo said that U.S. corporate investors in South Africa were there because they sought a "fair return on their investment," and that "where capitalism works, it works for everybody." This means that the ongoing economic development of South Africa implied a "fairer share of the pie" for non-white workers,

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Investment *continued*
more economic opportunities for them, especially in terms of upward mobility, and therefore more pressure for change in the apartheid system. Marrullo urged NAM member companies in South Africa to "stand up and be counted" by letting the public know what they are doing to promote economic opportunities and economic and social development for non-white workers. In addition, companies should point out the negative results of restrictive legislation on U.S. investment that had been proposed at the federal, state and local levels.

The final subject on the agenda was the reauthorization of the Overseas Private Investment Corporation (OPIC). Bruce Hatton, OPIC director of legislative affairs, was the featured speaker. He gave a thorough summary of OPIC's role as a federally funded and chartered (but self-financing) insurance and lending operation in the less-developed countries. Hatton noted the recently legislated increase in the authorized ceiling for annual OPIC insurance operations to $150 million, and the increase in direct loan authority to an annual $15 million. Hatton also stated that the OPIC board had not yet decided on what changes it would propose during next year's reauthorization. When the final proposal is publicly available, a summary will be published in *Trade & Industry*.

Canada: Facelift for FIRA

Fulfilling a recent election campaign promise, Canadian Prime Minister Brian Mulroney's Progressive Conservative government has proposed sweeping changes in the country's Foreign Investment Review Act. The changes would rename the present Foreign Investment Review Agency (FIRA), impose major limitations on its review mandate and add a new investment promotion function to its activities. As Industry Minister Sinclair Stevens said in introducing the new bill, "Canada's interests will be advanced by encouraging Canadian and non-Canadian investment, not by discouraging it."

Despite the important legislative changes and the new government's more positive outlook on foreign investment, FIRA—now to be called Investment Canada—will retain an important screening role, notably in the area of mergers and takeovers. And potential investors should remember that present FIRA rules remain in effect until the reforms are officially enacted, though Canadian Embassy sources believe that the new law may well be in place by January 1, 1986.

Review of New Investment Eliminated

The most significant change is the elimination of new business investment reviews. This change will apply across the board, except in "culturally sensitive" areas such as publishing and film production where all investments will continue to be screened and the requirement of formal approval by Investment Canada maintained. Also, the investment conditions of the Canadian National Energy Policy—designed to reduce foreign ownership of Canadian energy resources—remain in place as they are the product of separate energy sector legislation. The government intends, however, to make important modifications in this sector as well through separate legislation. Finally, despite the elimination of screening procedures for new investment, Investment Canada will continue to require notification of all foreign investment proposals, whether they be new investments or acquisition of existing businesses.

Acquisitions: Some Reduction of Controls

The story is more mixed regarding acquisitions. In summary:

- Review will be waived on all takeovers or mergers where less than $5 million of assets in Canada are involved.
- Review authority will be maintained on direct takeovers of Canadian businesses involving more than $5 million in total assets. *Direct acquisition* means foreign acquisition of the control of a Canadian business or of its Canadian parent through a merger or acquisition in Canada.
- Review authority will generally be waived on the indirect acquisition of a Canadian firm with between $5 million and $50 million in assets. *Indirect acquisition* means acquisition through merger with or takeover of a foreign parent firm. However, if more than 50 percent of the total international assets represented by such a transaction are in Canada, then the transaction will be reviewed.
- Review authority will be maintained over all transactions—either direct or indirect acquisitions—when more than $50 million in Canadian assets are involved.

In introducing the proposed changes, Minister Stevens declared that the changes would eliminate 90 percent of the individual transactions presently reviewed by FIRA, counting both takeovers and establishment of new businesses. He noted that the existing level of review was so pervasive that the entire cabinet recently had to decide whether a foreign individual should be allowed to set up a peanut stand in an Edmonton shopping mall. But Stevens also noted that in terms of dollar amounts, more than 90 percent of all foreign takeovers will still be subjected to review.

New Test: "Net Benefit" to Canada

One of the most controversial provisions of FIRA will be modified, though not eliminated, in all future reviewed transactions. This is the "significant benefit to Canada" test, whereby FIRA must presently determine that any reviewed transaction involve a "significant benefit to Canada," or face the possibility of disallowance. This includes even the transfer of ownership of a Canadian business between two non-Canadian parents. Under the new law, the test of significant benefit will be replaced by a "net benefit" test, under which it must only be clear that the losses implied for the Canadian economy in a reviewed transaction be outweighed by the presumed benefits. Assistant U.S. Trade Representative Harvey Bale expressed a positive reaction on behalf of the U.S. government to the proposed changes but had reservations over the interpretation of net benefits. And Thomas Walkom of the Toronto *Globe and Mail* provided a more critical reaction: "Many key elements of the old FIRA screening system remain intact. Most important of all, the final decision as to what constitutes a net benefit for Canada remains political. While Mr. Stevens is to become the final arbiter, rather than the cabinet as a whole, his decision cannot be appealed." Furthermore, Investment Canada will continue to keep confidential the conditions imposed on investors in order to gain approval, though Stevens has indicated that confidentiality practices may also be reviewed.

Besides the introduction of a presumably easier net benefits test, other efforts will be made to expedite the review process—bearing in mind that the approval process had already been streamlined under Liberal Industry Minister Ed Lumley and present FIRA Commissioner Robert Richardson before the Tories took office. Now Investment Canada will have just 45 days to approve an acquisition,

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Canada *continued*
with a maximum 30-day extension available upon its own request. An acquisition or other reviewed investment is deemed to be allowed if no decision is announced after 75 days. Under present law, FIRA can delay a decision indefinitely.

Initial U.S. business reaction toward the proposed changes was highly favorable. Lawrence A. Fox, NAM's vice president for international economic affairs, was quoted in the *Globe and Mail* as calling the changes a "step in the right direction," though he expressed disappointment at some of the residual powers left to Investment Canada. "If an investment is really good, why are they keeping score?" Fox asked. "The Canadian government hasn't deprived itself of the opportunity to meddle."

U.S. Trade Statistics*

(in $ billions)

	1984 Total Trade			Manufactured Goods		
	Exports	Imports	Balance	Exports	Imports	Balance
November	18.4	28.3	- 9.9	12.1	19.1	- 6.9
January-November	198.8	314.2	-115.4	130.8	213.5	-82.7
Annual Rate	216.9	342.8	-125.9	142.6	232.9	-90.2

1983 Totals

Merchandise Trade			Manufactured Goods		
Exports	Imports	Balance	Exports	Imports	Balance
200.5	269.9	- 69.4	132.4	170.0	-38.3

*Source: U.S. Department of Commerce; imports c.i.f.

Chairman **LaFalce**. Our next and last witness is Mr. Ronald Danielian, the president of the International Economic Policy Association.

I am pleased to have you before us once again, and again I would ask that you try to limit your oral remarks to approximately 10 minutes.

Mr. **Danielian**. Thank you, Mr. Chairman.

STATEMENT OF RONALD L. DANIELIAN, PRESIDENT, INTERNATIONAL ECONOMIC POLICY ASSOCIATION

Mr. **Danielian**. I am pleased to be invited to testify before your committee again. I am Ronald L. Danielian, president of the International Economic Policy Association, which was established in 1957 to analyze public policy issues in the international economic arena, including international trade, investment taxation, raw materials, and exchange rate policy questions.

We have published several books on the U.S. balance of payments and one on U.S. foreign economic strategy for the 1980's.

Mr. Chairman, this Nation is in trouble. We are running serious balance-of-payments deficits, building debts abroad which are future claims on U.S. resources. We continue to rely on the failed policies and floating exchange rates to make corrections.

In 1971, Mr. Chairman, my association testified before Congress that the use of flexible exchange rates as a solution to the American balance-of-payments deficits was a hangover from classical international trade theory and that it was not applicable to a world where the classical model of competition, free trade, and mobility of capital and labor simply does not apply. In 14 painful years, we haven't learned our lesson.

What is new today is the severity of the situation. Imports account for 10 percent of our GNP, while over a decade ago they were about 2 percent. They have accounted for 15 percent of our domestic demand for goods in 1984, a full one-third greater than 5 years before.

Imports, aided by misaligned currencies, have a depressing effect on certain sectors of our domestic economy, creating imbalances, which you mentioned in your opening statement.

The industrial production index has been flat for almost 9 months, according to Paul Volcker, and employment in the manufacturing industries has not grown recently. We believe that the stagnation in employment in these industries and the dislocations in manufacturing, agriculture, and mining are closely related to the trade deficit, fed by foreign barriers and currency shifts.

Import penetration is so severe that the capital goods industries have lost 387,000 jobs since 1980, and combined with auto and other transport equipment, the job loss amounts to about 500,000.

Last year, one-half of every dollar spent on capital equipment went for overseas purchases; 40 to 50 percent of domestic machine tool sales in the United States has come from abroad.

We believe that currency swings are responsible for up to $50 billion of our trade deficit. In addition, as mentioned by other members of this panel, the U.S. budget deficit is a serious drain on resources. It encourages current consumption through the borrowing of foreign funds, building up liabilities abroad, and bringing higher interest rates that affect the dollar's value.

It is extremely important to reduce this deficit as one part of the program, but that would not be the cure-all. Our trade and balance of payments deficits transcend this era of very high budget deficits, and we are still facing nontariff barriers abroad which we must eliminate if we are to preserve an open trading environment.

The United States faces a crisis in its ability to earn foreign exchange, to pay its way in the world today without borrowing from foreigners and mortgaging the future. Yet these problems have been building for years. They are not new. We have had sizable trade deficits since 1971 and a current account deficit on actual transactions since 1968.

The problem is that our investment and services accounts can no longer overcome our deficit in trade. Our hemorrhage of foreign exchange earnings exploded in 1977 and has remained high ever since. Even in previous years, however, stretching all the way back to 1950, under former measures of our balance of payments, we have run deficits and built up dollar liabilities abroad.

The nature of U.S. trading relationships has changed over the years, and our flow of trade has risen faster with new areas, such as Asia, than with previous markets such as Europe. And our overall balance has shifted from near balance or positive to deficits with all major areas.

Table I of my full statement shows the deficit in our trading relationships with the various areas of the world. In major product categories, except for agriculture, the United States is suffering from ever-increasing trade deficits or a substantially reduced surplus, and even in agriculture our surplus has slipped as U.S. policy mistakes, such as embargoes, have allowed competitors to garner a significant share of what used to be our primary foreign markets.

Table II, A through E, shows the balance in major product categories since 1957. The same pattern is repeating itself on the services account where our surplus on services is being reduced.

Table III shows the real current account position, which incorporates the services account, and our overall trade position from 1960 to 1984. In the last decade, despite continual drives to open up foreign markets, only in the depths of the recession of 1975 did the United States have a surplus on the current account.

The present administration does not seem to view the current account deficit with too much alarm. Unfortunately, they view the balance of payments with the same benign neglect that past administrations have viewed floating exchange rates.

There is a relaxed air that the current account deficit merely implies that U.S. residents are purchasing more goods and services than they are now producing, and its counterpart is a capital account surplus which measures the net claims on U.S. residents that foreign residents have accepted in payment.

Well, this is true, but the administration views that net capital inflow provides the financing for an excess of current expenditure over output. That is a very simple assets and liabilities account of our international transactions, but the key flaw is the implied assumption that net claims can keep on rising.

What we have done is switched in the last decade from being on the healthy side of the assets and liabilities statement to the unhealthy side, wherein we sustain our growth on borrowed funds, building up foreign claim against the United States. This is no different than our domestic budget deficit building up future claims on generations which ultimately must pay.

In classical economic terms, economies paid off international debts through earning more by reducing internal consumption, saving capacity for export earnings—for foreign exchange.

Countries in balance-of-payments deficit needed to bring down the level of domestic activity relative to the rest of the world.

When we must prepare ourselves to pay off these future international claims, interest charges will mount as we try to live on borrowed money rather than building future earning assets. There will be less available for actual growth in our economy, and when the burden reaches its peak the dollar will depreciate and inflation will follow.

We may face October 1979 all over again, when interest rates rose as the Fed increased the discount rate twice in 1 month and credit controls were applied.

As Benjamin Franklin said, "Few things are harder to put up with than the annoyance of a good example." And we should learn by the example of the United Kingdom, where growing debt and balance-of-payments crises forced them into stop-go economic policies of the late 1960's and early 1970's. Most important, however, were the strategic implications of the British problem.

The severity of their payments crisis reached a peak toward the end of the 1960's when the pound became one of the sick men of Europe.

In 1967, sterling was devalued but the crisis persisted. Later world bankers gathered in Basel to put together a sterling guarantee package. But Britain's problems finally came to a head and lead to reassessment of its ability to continue financing overseas activities with foreign exchange that it did not have.

One casuality was overseas defense expenditures, which could no longer be sustained at previous levels. Britain pulled back from its East of Suez military obligations, especially the Middle East and the Indian Ocean, to save foreign exchange costs.

I believe that we could potentially find ourselves in the same kind of situation where we must restrict internal domestic demand to save domestic production for export rather than internal consumption. Down this route lies a significant change in our terms of trade and a reduction in U.S. living standards. We cannot live on borrowed funds indefinitely. We can do so in the short term only at the cost of higher interest rates to attract foreign funds and the loss of more jobs and investment as the dollar stays overvalued and other currencies are undervalued.

Ultimately, we may face a foreign exchange crisis where we will not have the freedom to allow Americans unrestricted travel, we will not have the freedom to import what we want, we will be restricted on our foreign operations.

Because the U.S. dollar has not responded according to classical theory, world trade is no longer being conducted on the basis of comparative advantage causing a distinct inefficiency in the flow of resources on a global basis.

The real question in forming a solution is, how do you make the system adjust for different national policy complexions without resorting to pure protectionism. We need a new direction in international economic policy. We have suffered from a delayed perception of basic changes in world economic forces. No longer the largest single economic group in the world, we cannot act as if the rest of the world will automatically follow us.

Our past negotiating style has been to open up our markets without really making sure that other markets have been truly open to us. We have had political objectives in negotiating agreements and these objectives have sometimes overshadowed the economics.

In the past, international trade was not a significant part of the U.S. economy and we could afford to give away some of our markets. The economic landscape today is vastly different. We do not have an economic surplus in foreign exchange terms with which to grant unilateral concessions to foreign nations.

With certain countries we have had a continuing problem that we have failed to address. This is the case with Japan which represents a different and unique situation that cannot be hidden by the fact that in 1985 we have substantial deficits with other trading partners.

Table VI of my statement shows our trade and current account deficit with Japan since 1960 and, as can be seen, the problem is not of a current nature. Both accounts have been in deficit in every year since 1965.

As we enter our third decade of deficits here, it is difficult to fall back on the excuse that U.S. trade problems go beyond Japan or that all we need is more time for some of us to believe that three decades is enough time.

The most striking anomoly in these figures is that the U.S. trade and current accounts have not responded in the past to what theory and common sense tells us should happen when one economy grows faster than the other and when one currency depreciates in value against another.

This is especially true when the U.S. dollar declined by up to 30 percent between 1978 and 1980, Mr. Chairman.

Many have argued that our trade deficit will eventually improve as rates of economic expansion in the United States and Japan come closer. In addition, if the dollar depreciates, our trade should also improve with Japan.

The contrary, however, is closer to the truth in this country, I believe. The facts of United States-Japanese trade simply do not support the normal economic principle that aggregate internal demand or the depreciation of the dollar will be a prime mover in increasing trade and correcting our deficit with this country.

And the recent plea that "Japan isn't the only problem" is a half-truth, used as a smokescreen to cloud the issue. U.S. policies must change to reflect the problems we now face.

As Abraham Lincoln said, "As our case is new, so we must think anew and act anew."

To find our way back to a policy of expanding rather than restricting the opportunities for trade, we must regain control of access to the U.S. market so that negotiations can be successful in obtaining respect for the principles of most favored nation, national and reciprocal treatment.

Access to our markets must be conditional on adherence and practice to these principles by other countries, and the application of the principles should not be confined merely to trade movements. It must encompass investment, repatriation of earnings, industrial property rights, and any other considerations of quantitated economic value.

Economic progress, Mr. Chairman, is indivisible. Trade, investment, property rights, travel, and other parts of the balance of payments are all interdependent and a misalignment in one leads to problems in the other.

While we should never openly protect any inefficient industries through trade barriers, we should not allow the actions of others to force us into noncompetitive positions where we maintain a comparative advantage.

I've outlined in my full statement what I believe are the first steps necessary to make adjustments for a new direction toward an open, efficient trading system. And these include: Use of conditional most-favored-nation status for future access to U.S. markets; a resolve not to use voluntary quotas for controlling imports in crisis situations but, rather, to rely on bilateral discussions on increased tariff rates as a preferred method so that the market mechanism of supply and demand can operate and we do not enrich the foreign producer at the expense of Americans.

We must demand a basic reciprocity and national treatment in both trade and investments. The aim here is the ultimate opening of the other countries market, not a closing of our market.

The United States should adhere to a broad sector-by-sector negotiations so that industries of like value are treated equally as set forth in the Trade Act of 1974.

The United States must meet foreign export financing subsidies, which means domestically we must be prepared to fund the Export-Import Bank with whatever amounts are necessary, and we must be prepared to support other Government agencies promoting exports.

The United States should initiate bilateral and multilateral agreements to phaseout trade distorting subsidies, and where agreement cannot be reached, action must be taken on the subsidized imports.

We must undertake bilateral and multilateral agreements to insure respect for international property rights, and we should deny automatic safeguards here in the United States for countries violating this principle.

We must insist that performance requirements be avoided on our foreign investments. The degree of access to the U.S. market should also consider such requirements as they should be a part of a negotiating process.

Domestic adjustment assistance to firms and workers must be reshaped into a coordinated program to help firms redefine their operations and to help workers retrain for higher level skills.

The United States should make use of article XII again on restrictions to safeguard the balance of payments. We should not be afraid to use internationally recognized tools as corrective measures. Before such use, we should explore, in joint consultations under GATT, the possibility of the use of this article on a bilateral basis, which recognizes that the world has changed since GATT was originally written.

Consideration should be given to the study and use of exchange adjusted tariffs to adjust the trade effect on misaligned currencies and return us to a system of open markets that compete on the basis of comparative advantage in real cost.

Mr. Chairman, I've appreciated a chance to give your committee my views about what many regard as a critical problem. Some of my suggestions might seem unorthodox but they highlight my view that we cannot wait for reductions in our budget deficit—although, that is extremely important—to lower our interest rates and dollar exchange rates.

We must, in fact, be more aggressive in maintaining open markets.

Thank you, Mr. Chairman.

Chairman LaFalce. Thank you very much, Mr. Danielian.

[The prepared statement of Mr. Danielian, on behalf of the International Economic Policy Association, follows:]

STATEMENT OF RONALD L. DANIELIAN
PRESIDENT, INTERNATIONAL ECONOMIC POLICY ASSOCIATION
BEFORE THE
SUBCOMMITTEE ON ECONOMIC STABILIZATION
OF THE
COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS
U. S. HOUSE OF REPRESENTATIVES

April 16, 1985

Mr. Chairman:

Thank you for inviting us to testify at your hearings on the trade deficit, exchange rates and the U.S. economy. My name is Ronald L. Danielian and I am president of the International Economic Policy Association--established in 1957 as the first nonprofit organization to analyze public policy issues in the international economic arena. These have included international trade, investment, taxation, raw materials, and exchange rate policy questions as well as international monetary issues. We have published several books on the U.S. balance of payments and one on U.S. Foreign Economic Strategy for the Eighties.

Mr. Chairman, this nation is in trouble. We are running serious balance of payments and trade deficits, building debts abroad which are future claims on U.S. resources. We continue to rely on the failed policies and floating exchange rates to make corrections. In 1971 we testified before Congress that the use of flexible exchange rates as a solution to the American balance of payments deficits was a hangover from classical international trade theory and that it was not applicable to a world where the classical model of competition, free trade, and mobility of capital and labor simply does not apply. In fourteen painful years we haven't yet learned our lesson.

What is new today is the severity involved. Imports account for 10 percent of our GNP, while over a decade ago they were about 2 percent. They accounted for 15 percent of our domestic demand for goods in 1984, a full one-third greater than five years before. Imports (aided by misaligned currencies) have a depressing effect on certain sectors of our domestic economy, creating economic imbalances. The industrial production index has been flat for almost nine months and employment in the manufacturing industries has not grown recently. We believe that the stagnation in employment and the dislocating effects on manufacturing, agriculture, and mining is closely related to our trade deficits, fed by foreign barriers and currency shifts.

Import penetration is so severe that:

- The capital goods industries have lost 387,000 jobs since 1980 and combined with auto and other transport employment, the job loss has equalled 500,000.
- Last year one-half of every dollar spent on capital equipment went for overseas purchases.
- 40 to 50 percent of domestic machine tool sales in the United States has come from abroad.

We believe that currency swings are responsible for up to $50 billion of our trade deficit. In addition, the U.S. budget deficit is a serious drain on our resources which continues current consumption by borrowing foreign funds, building up liabilities abroad. It has also necessitated higher interest rates affecting the dollar's value. It is extremely important to reduce this deficit as one part of the puzzle. Nevertheless, it is not the cureall. Our trade and balance of payments deficits transcend this current era of very high budget deficits. And we are still facing nontariff barriers abroad which we must eliminate if we are to preserve an open world trading environment.

"The nearer any disease approaches to a crisis,
the nearer it is to cure."
-- T. Paine

The United States faces a crisis in its ability to earn foreign exchange and pay its way in the world today without borrowing from foreigners and mortgaging the future. Yet these problems have been building for years and transcend the era of bloated budget deficits. Except for the recession year of 1975, we have suffered sizable trade deficits since 1971, and those deficits have mushroomed in the 1980s to $123 billion ($108 on a balance of payments basis).

Our investment and services account can no longer overcome our deficit in trade. Thus, the United States current account measuring all current international transactions was in deficit by $102 billion in 1984. This, too, is not a recent phenomenon. In fact, the United States current account on actual transactions (excluding the overstatement of net reinvested earnings) has been in deficit since 1968 (excluding the recession year of 1975). In the past, however, our current account deficits on actual transactions were manageable, ranging between $1 billion and $9 billion. They could be financed by reasonable inflows of capital from overseas and in aggregate terms up until about the mid-1970s, the cumulative balance was positive.

For the current account, we were able to cover our imports of goods and the cost of military expenditures abroad through the sale of U.S. services, the return on U.S. foreign assets in the form of repatriated income from U.S. direct investors overseas and small manageable inflows of foreign capital. Starting in 1977, however, the hemorrhage both in our trade and our current account was too severe for our export earnings or return on investments and services sales abroad to balance out--even over time. Considering this imbalance in our accounts, we stand today as one of the world's largest debtor nations--exceeding in one year the total debt of Mexico. Our ability to spend abroad relies on the inflow of foreign funds, attracted by today's extremely high real interest rates. Thus, to finance military and aid expenditures abroad, and to allow foreign goods unrestricted access to the U.S. market without the quid pro quo of open access for our goods, we must borrow money.

It must be noted that this excess of expenditures over earnings persisted in earlier years under the former measures of our balance of payments. These measures included first the liquidity balance, the official settlements balance, and the basic balance used at various times up to 1972. No matter how the definitions were changed, we still had a deficit and built up dollar liabilities abroad.[1]

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[1] The United States Balance of Payments: From Crisis to Controversy, (1972), IEPA, Washington, D.C.

The United States Balance of Payments: A Reappraisal (1968), IEPA, Washington. D. C.

The United States Balance of Payments: An Appraisal of the U.S. Economic Strategy (1966), IEPA, Washington, D.C.

"Change is the password of growing states."
-- G. E. Woodberry

The nature of the U.S. trading relationships has changed over the years and our flow of trade has risen faster, with new areas such as Asia than with previous markets such as Europe. And our overall trade balances have shifted from near balance or positive to deficits with all major areas. Table I shows the deficit in our trading relationships with various areas of the world. In major product categories, except for agriculture, the United States is suffering from ever-increasing trade deficits or a substantially reduced surplus. And even in agriculture our surplus has slipped as U.S. policy mistakes such as embargoes have allowed competitors to garner a significant share of what used to be our primary foreign markets. Table II (a-e) shows the balance in major product categories since 1957. The same pattern is repeating itself on the services account where our surplus on services is being reduced. Table III shows the real current account position and overall trade position from 1960-1984. In the last decade, despite continual drives to open up foreign markets, only in the depths of the recession in 1975 did the United States have a surplus on the current account.

This deficit transcends our extremely high budget deficits of today. If you lower our budget deficit, it will have an effect on the current account but it will not solve our problem, which has been longstanding, as Table III shows.

"A little neglect may breed great mischief."
-- B. Franklin

The international report of the President's Council of Economic Advisers does not view the current account deficit with alarm. Unfortunately, they view the balance of payments with the same benign neglect that past administrations had viewed floating exchange rates. The report states that the "deficit is not necessarily a negative factor for the economy as a whole. A current account deficit merely implies that . . . U.S. residents are purchasing more goods and services than they are now producing. Its counterpart is a capital account surplus which measures the net claims on U.S. residents that foreign residents have accepted in payment. Thus, net capital inflow provides the financing for an excess of current expenditure over output."

This statement is an assets and liabilities account of our international transactions. Just as with any corporation, assets and liabilities must balance out. But one can pick American companies that are in difficult times, earning no profits (possibly paying dividends with borrowed funds), whose assets and liabilities balance. The key flaw in the statement is the implied assumption that "net claims" can keep on rising.

In much the same way for the United States, we have switched in the last decade from being on the healthy side of the assets and liabilities statement to the unhealthy side where we sustain our growth on borrowed funds, building up foreign claims against the United States. This is no different than our domestic budget deficit building up future claims on generations which must ultimately pay. Similarly, the United States must be prepared in the future to pay off its international claims. As interest charges mount and as we try to live on borrowed money rather than building future earning assets, there will be less and less for growth. When the burden reaches its peak and the dollar depreciates, inflation will follow. We will face October 1979 all over again when interest rates rose as the Fed increased the discount rate twice in one month and credit controls were applied.

In classical economic terms, economies paid off international debts through earning more by reducing internal domestic consumption to save the productive capacity for export earnings -- foreign exchange. Countries in balance of payments deficit needed to bring down the level of domestic economic activity relative to the rest of the world. Major domestic adjustments similar to the IMF prescriptions for the debt-ridden LDCs are most appropriate.

> "Few things are harder to put up with
> than the annoyance of a good example."
> -- B. Franklin

Growing debt and balance of payments crises forced the British into stop-go economic policies of the late sixties and early seventies. Most important, however, was the strategic implications of the British problems. The growth of foreign income from earning assets abroad filled in for the lack of foreign exchange created by constant trade and services deficits in the 19th and first part of the 20th century, and supplied most of the surpluses for her foreign activities.[1] But the forced sale of overseas private investments to meet war obligations cut earnings. This plus a substantial rise in military expenditures[2] ultimately led to chronic debt and overall balance of payments problems after World War II.

The severity of their payments crisis reached a peak toward the end of the 1960s when the pound became one of the "sick men" of Europe. In 1967, sterling was devalued by 14.3 percent, yet the crisis persisted. Later, world bankers met in Basel to agree on a "sterling guarentee" package. The massive sterling problems and the stop-go economic policies tried as a cure finally led to a reassessment of England's ability to continue financing overseas activities. One casualty was overseas defense expenditures which could no longer be sustained at previous levels. Britain pulled back from its "East of Suez" military obligations (especially the Middle East and Indian Ocean) in part to save the foreign exchange costs which were no longer sustainable and in part to satisfy the political orientation of the labor government.

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[1] See: Economic Elements of The Pax Britannica, Albert Imlah, Harvard University Press, Cambridge, 1958.

[2] Britain's Economic Prospects, the Brookings Institution, Richard Caves and Associates, 1968.

The United States could potentially find itself in the situation where we must restrict internal domestic demand to save domestic production for export rather than internal consumption. Down this route lies a significant change in our terms of trade and a reduction in U.S. living standards. The United States cannot live on borrowed funds indefinitely. We can do so in the short term at the cost of higher interest rates (to attract foreign funds) and loss of jobs and investment as the dollar stays overvalued and other currencies are undervalued. In addition, our ability to function internationally hinges on the dollar's acceptance as a universal medium of exchange, but the time may come when we will have to face a new reality. That will be when the dollar is used less and less as an international reserve and the currency of other groups of nations takes over as a reserve. The pattern is not unlike what happened to the pound sterling when its role as a major reserve currency began to falter and waned in the latter part of the 1960s. Then we will not have the freedom to allow Americans unrestricted travel, we will not have the freedom to import what we want, and we will be restricted in our foreign operations.

> "The Almighty Dollar, that great object of universal devotion throughout our land."
>
> -- Washington Irving

U.S. productive efficiency has actually increased over the past few years while the U.S. current account balance has been falling sharply. U.S. overall productivity has advanced at a faster annual rate than in the past--at 3 percent--and U.S. industry has become extremely productive. In manufacturing alone, however, U.S. productivity rates have increased faster but in relation to our trading partners our performance has been lagging (see Table IV). Yet we need to attract over $80 billion to cover a current account deficit and continue our domestic economic expansion. But in doing this, capital shifts have swelled the value of the dollar to such an extent that productivity increases alone are not able to overcome the 30-40 percent overvaluation of the dollar or undervaluation of other currencies.

Under normal circumstances, the U.S. exchange rate should be depreciating so that we could overcome our payments imbalance. Because it is not, world trade is no longer being conducted on the basis of comparative advantage, causing a distinct inefficiency in the flow of resources on a global basis. As an example, the United States has always been the most efficient agricultural producer in the world. At one time our agricultural products could be produced and sold for less than half the cost of comparable products in other countries. That is no longer the case today as we have reached the point where U.S. agricultural companies such as Cargill have even considered importing grains into the United States because in dollar terms it's cheaper than buying in the U.S. farm belt! In the past, the European Common Agricultural Policy subsidized the exports of their products up to 50 percent of the cost of production. But because of the strength of the dollar,(in foreign exchange) terms U.S. agricultural products are so expensive now, that there is almost no subsidy element in

European exports to third country markets. This is true despite the fact that in local terms it can cost twice as much to produce agricultural products in Europe as it does in the United States.

In the export of goods, the United States was the number one producer of commercial aircraft in the world, but we no longer hold that position because of severe competition from European and other manufacturing bases. A major factor in the continuing loss of market share in this product has been the substantial overvaluation of the dollar. Pan American World Airways, for instance, has broken with a long history of association with the Boeing Aircraft company to buy up to 28 airbuses worth approximately $1 billion. This is despite the fact that its present system is geared, from mechanics to spare parts, to the Boeing aircraft. In foreign exchange terms, the 30 percent overvaluation of the dollar had a significant impact on bringing down the dollar cost of that equipment purchase. Since the export credit agencies in Europe assume the risk for exchange rate fluctuations without charging a premium for airbus sales financed in dollars, a potential $300-$400 million savings can be passed on to the buyer. This is a tremendous price advantage hurdle for an American airframe manufacturer to overcome.

> "A condition confronts us--not a theory."
> -- Grover Cleveland

The use of classical theory to frame a policy of floating exchange rates that self-equilibrate international payments has been misplaced. It was first expected that floating exchange rates would free national economic policies from exchange rate concerns.

By automatically adjusting, it was felt, the market would remove the need for governments to defend a fixed rate and give nations greater freedom to adopt macroeconomic policies in pursuit of purely domestic targets for employment and growth. The exact opposite is more the case.

Fourteen painful years of strains in the international economy, loss of market shares for the United States, and reduced potential GNP growth have shown that we were right when we stated in 1971 that "There is now a fad of urging flexible exchange rates or revaluation of other currencies, that is to say, a de facto devaluation of the dollar as a solution to American balance of payments deficits. The belief that flexible exchange rates or revaluation of other currencies will turn the trick on our commercial transactions is a hangover from classical international trade theory. Unfortunately, this is not applicable to a world where the classical model of competition, free trade, and mobility of capital and labor, simply does not apply."[1]

For floating rates to work as envisioned, world nations would have to get together and adjust relative fiscal and monetary policies for an appropriate mix. Some nations would have to be willing to give up employment or growth and others would have to allow more inflation. It is extremely difficult to imagine countries of vastly different political, social or economic persuasion voluntarily agreeing on a yearly basis on such targets. The real question in forming a solution is, how do you make the system adjust for different national policy complexions without resorting to pure protectionism?

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[1] May 1971 IEPA statement before the Senate Finance Committee.

Protectionism is inefficient and raises costs to all concerned, yet the greatest protectionist move on a global basis is the existence of a grossly under or overvalued currency. It provides a tax or subsidy, whichever the case may be, and instills inefficiencies in the global movement of goods, services, and investments. New policies are needed to extricate ourselves from this problem; a new direction is appropriate.

"All things must change to something new."
-- H. W. Longfellow

American needs a new direction for its international economic policy. The United States has suffered from a delayed perception of basic changes in world economic forces. We are no longer the largest single economic group in the world, and we cannot act as if the rest of the world will automatically follow us. When the General Agreement on Tariffs and Trade was negotiated in 1948, it was biased in favor of countries needing our help; for instance through inclusion of the grandfather clause continuing the British Commonwealth preference system, and the authorization for common markets and free trade areas in the interest of Western European unity, even though these are, on their face, clear denials of the unconditional, most-favored-nation principle inherent in the document. During successive rounds of negotiations, stemming back to the 1950s, we adhered to the principle of MFN. We thus allowed third parties, who were emerging industrial powers, the ability to obtain favorable tariff rates on imports into the

United States without necessarily giving us a reciprocal bargain. Our objectives then leaned more toward helping others because we could afford to at minimal U.S. cost.

When final world levels on automobile tariffs were negotiated under the Kennedy Round in 1968, the United States ultimately agreed to a low duty rate of about two percent. The Japanese were able to receive the same low dutiable rate under MFN while their rates on automobile imports remained high, and while they denied and restricted the ability of U.S. automobile firms to invest in Japan. Of course, Japan was not a significant producer of autos--Europe was the second largest producer, and there was a complementary relationship between trade and investment as both were freely allowed across the Atlantic. Yet, as markets changed, the static agreement made under past conditions did not, and there was no opportunity for a complementary trade and investment relationship across the Pacific. This relationship is a key to why our trade and payments imbalance did not move toward extremes as is the case with Japan today.

In 1960, we agreed to a separate interpretation of Article XVI of GATT defining our direct income taxes as not rebatable, and European cascade or value-added taxes as rebatable on exports and charged against imports. This was at the suggestion of the French and was thought to be a help to encourage a greater cohesion within the Common Market so that our dream of a political as well as economic union would be fulfilled. Yet the world today has changed from our past perceptions, but our policies haven't.

In 1968, we allowed negotiations under the Kennedy Round to be completed in the nonagricultural sector alone--a sector in which the United States had been in a trade deficit. But we set aside discussions in the agricultural sector--at the time our primary breadwinner. In the later 1970s, we agreed to lower our dutiable rates on telecommunications equipment from Canada to a two percent level while Canada remained at a 17 percent duty for our shipments to them. And in 1979, under the Trade Agreements Act of 1979, the U.S. Congress sanctioned for the first time in law the 1960 interpretation that U.S. direct income taxes are not rebatable on exports. The world had changed considerably but our negotiators stuck to old beliefs. Nevertheless, the United States in public statements continued to fret over the fact that such tax rebates lead to a less than equal opportunity to compete, especially in third country markets. Our DISC, now the FSC, was an effort to equalize the playing field.

Even today, we are willing to give unilateral economic benefits to others for some undefined political reasons. The U.S. Administration appears willing, for instance, to ask for application of the harder standard of an injury test on unfair or countervailing trade practices with Mexico. Despite the fact that Mexican performance requirements on investment are tantamount to a kidnapped plant policy--come down and invest or lose your present stake and when you invest you must export. I also understand that the Congress has not been told exactly what we are prepared to give up and the justification therefore in exchange for achieving an opening for services trade in new MTN negotiations. I would hope we don't rush in and give up another sector such as agriculture.

> "Let us have the courage to stop borrowing to meet continuing deficits."
> -- Franklin Delano Roosevelt

The United States does not have an economic surplus in foreign exchange terms with which to grant unilateral concessions to foreign nations. We cannot afford to give up access to our markets for some undefined objective without making sure that such access is fully reciprocal. The expenditure of foreign exchange for activities that do not bring an economic return can lead to an increase in our international payments deficit. For instance, there are times when we should not be put in the position of giving aid in money terms. Rather, the United States should supply to the world real (hard goods) resources, of which we have an abundance, considering our present excess capacity. We can afford to give tractors, pay for U.S. engineers or other U.S. services to be performed in foreign lands as a gesture of our compassion and aid to the rest of the world. Or we can afford to give surplus food to those in need. We cannot afford to give dollars freely since we are one of the world's largest debtor nations . . . to give we must borrow.

Of course, this is parallel to our domestic budget deficit--to spend on government programs we must borrow.

"There is nothing so powerful as truth;
and often nothing as strange."
--Daniel Webster

It is not realized by most that in foreign exchange terms on an overall basis the United States has had a balance of payments deficit since 1950, except in 1957 after the Suez crisis. We built up liquid liabilities abroad (the old liquidity payments balance) as government expenditures for aid and defense outstripped our commercial surpluses. Later, on an official settlements basis, we continued to build up dollar liabilities abroad. On a basic balance basis (the current account plus long-term transactions)[1], we also ran a deficit. Today, on a current account basis, we still have significant deficits.

On a commercial basis, we have had persistent trade deficits since 1971 (in 1977 they reached crisis proportions) and current account deficits since 1968 (see Table III). The fact that we have been running deficits means that we are transferring purchasing power to foreigners, in essence, giving future claims to U.S. resources. In the 1980s, our deficits on both accounts have mushroomed to crisis proportions and year after year we are building up more liabilities abroad. In a detailed look at our trade and official current account balances with various regions, the truth is indeed strange.

Table V shows our balances with major countries and major areas of the world, constituting countries which are our major trading partners. Excluded from these tables is Japan which I shall treat separately. As can be seen, our accounts with these areas have varied between surplus and deficit, except of course starting in 1983 when universally we began to run trade and/or current account deficits with all of our major trading areas. It is interesting to note, however, that while our problem is serious and our accounts have deteriorated, it is even more critical with Japan. While recent talk that "Japan isn't the only problem," may be true today, it is a smokescreen that clouds the problem.

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[1] For a description of these past measurements and a historical perspective of the facts, see: The United States Balance of Payments: An Appraisal of U.S. Economic Strategy, IEPA, 1966, p. 159.

With Canada, for instance, the United States had a $10 billion trade deficit in 1983, but we still had a small current account surplus. For Germany alone the special problem of our NATO expenditures there accounts, at times, for 75 percent of our current account deficit. This is an issue that must be considered separately.

Because of the tremendous rise in the value of the dollar and the decline in the value of other currencies, the final figures for 1984 show a further massive deterioration in our accounts. But what can be seen by this historical perspective is that in those times when the dollar was depreciating substantially, by up to 30 percent, such as between 1978 and 1980, our trade accounts and/or current accounts responded accordingly--we were able to sell more and improve our foreign exchange earnings.[1] This, however, has not been true with regard to Japan. In fact, Japan represents a different and unique case which cannot be hidden by the fact that today in 1985 we have substantial deficits with our other trading partners.

Table VI shows our trade and current account deficits with Japan since 1960. As can be clearly seen, our Japanese problem is not one that is of a current nature. We have had a growing trade and current account deficit with Japan in every year since 1965. As we enter our third decade of problems in this area, it is difficult to fall back on the excuse that U.S. trade problems go beyond Japan... or that all we need is more time. The most striking anomaly with Japan is that the U.S. trade and current accounts have not responded in the past to what theory and common sense tell us should happen when one economy grows faster than another and when one currency depreciates in value against another.

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[1] A depreciation can help but is muted by the "J" curve lag in trade effects, and because some countries peg their currencies to float with or below the dollar. About 65 percent of our trade is with such currencies; thus, less benefit would accrue to the U.S. from these nations.

Many have argued that our trade deficit will eventually improve as rates of economic expansion in the United States and Japan come closer. In addition, if the dollar depreciates, our trade should also improve with Japan. The contrary, however, is closer to the truth. The facts of U.S.-Japanese trade simply do not support the normal economic principal that aggregate internal demand or a depreciation of the dollar will be a prime mover in increasing trade and correcting our deficit with this country.

For instance, in every year since 1973, the growth in Japanese gross domestic product (a good proxy for internal aggregate demand) has exceeded that of the United States. In fact, in the years 1978 through 1980 (a period when the dollar was depreciating by 30 percent, which should have given us an additional trade advantage), Japanese growth significantly outperformed U.S. growth. Thus, we should have had substantial added U.S. trade opportunities, leading to a significant correction in our trade balance with Japan. Instead, however, our deficit with Japan hovered between $8.6 billion and $11.6 billion. In 1979, real growth in Japanese GDP was 5.1 percent versus 2.3 percent in the United States, and in 1980, it was 4.9 percent versus -0.2 percent in the U.S., yet our trade deficit increased from $8.6 percent to $10.4 billion. In 1981, Japan grew one full percentage point faster than the United States, while our trade deficit increased from $10.4 to $15.8 billion. And in 1982, while Japan grew at a positive rate of 3.2 percent and we were in the throes of a recession with a -2.4 percent decline, our trade deficit increased by another $1 billion! This probably reflects the unrealistic strengthening of the U.S. dollar or the corresponding weakness of the Japanese yen; but throughout the last decade, more than just currency swings or domestic growth would have been necessary to tackle the "Japan problem."

I maintain that U.S. policies must change to reflect these facts.

> "As our case is new, so we must think anew and act anew."
> --A. Lincoln

We can find our way back to a policy of expanding rather than restricting the opportunities for trade by regaining control of access to the U.S. market so that in negotiations we can be successful in obtaining respect for the principles of MFN, national and reciprocal treatment. Access to our markets must be conditional on adherence in practice to these principles by other countries, and the application of the principles should not be confined merely to trade movements. It must encompass investments, repatriation of earnings, industrial property rights, and any other considerations of quantitative economic value.

Economic progress is indivisible; trade, investment, property rights, travel, and other parts of the balance of payments are all interdependent and a misalignment in one leads to problems in others.

We must realize that today's world is different than that of the fifties and sixties. As just one of the major international economic players, the United States should cease to act as if its size and status obligated it to a higher standard of self-sacrifice than any other major country. There is, of course, some continuing validity to this notion, but the special conditions which prevailed after World War II and Korea have been corrected in part due to America's generosity. Having met our special obligations imposed by our relative affluence at that time, the United States now should begin to act as coequal with other countries. We have major domestic priorities and problems of our own. And while we must continue to carry out our basic responsibilities as in the past, we also must insist on a more open and reciprocal treatment in our economic relationships in the future.

We should never openly protect inefficient industries through trade barriers, but we should not allow the actions of others to force us into noncompetitive positions.

In order to make the necessary adjustments for a new direction towards an open efficient trading system, we should follow the principles as laid down under Section A below. These principles have been long held by IEPA and for the most part are not significant departures from accepted rules or practices today. Under Section B, we propose some principles that should be considered if imbalances and severe dislocations persist. These proposals in some cases may be legal remedies accepted by the trading community or may be more controversial. But they are forwarded in an effort to forestall pure protectionist reactions.

Section A

A-1. The United States must use a conditional most-favored-nation trade status that rests on the goals of reciprocity and national treatment in both trade and investments. In insisting upon and obtaining true respect for the principles of national, reciprocal and MFN treatment, future access to our markets should be conditioned on adherence in practice to these principles by our trading partners. Third countries which do not agree to the stipulations between two trading partners should not benefit to the same degree from the lowering of barriers between the two primary parties. The effort here is to structure our negotiations along the lines of the Tokyo Round MTN government procurement code, subsidies code and other agreements. Only countries who agree to codes get the benefits of the codes and those who do not, receive none.

A-2. Voluntary quotas should not be used for controlling imports in crisis situations, but temporary increased tariff rates should be the preferred method. The United States must consider the use of tariffs rather than quotas when undertaking bilateral negotiations with other countries, such as in orderly marketing agreements. Strict adherence to quotas does not allow the market mechanism to operate and in fact can enrich the foreign importer at the expense of the U.S. consumer. It has been variously estimated, for instance, that Japanese automakers are earning anywhere from three-quarters to one hundred percent of their profits in the United States, because of the quota limitations imposed upon them. On an annual basis, the FTC has estimated that quotas swelled the profits of Japanese companies by $824 million but by only $115 million for U.S. companies. By applying a tariff, the economic rent of higher prices is collected by the U.S. Government, not by the foreign manufacturer. If the foreign manufacturer wishes to maintain his market share or a new entrant wishes to begin operations here, the price effects of supply and demand can operate under tariffs--but not under a quota.

A.-3. The United States must demand a basic reciprocity and national treatment in trade and investments. Reciprocity here should be the natural outgrowth of an agreement between nations to clear barriers and maintain open trading relationships. We should not unilaterally agree to open our markets for some undefined benefit in the future.

National treatment assures no less favorable treatment for U.S. investors in a foreign nation than that which is accorded its own nationals. Thus, this is an adherence to a principle of nondiscrimination. For those countries which do not allow private ownership of property or means of production, or restrict certain sectors to purely government ownership, their ability to freely invest in the United States can be handled on a case-by-case basis. The objective in both reciprocity and national treatment must be an ultimate opening of the other country's market, not a closing of ours. We should never recede into a "tit for tat" mentality which revokes previously agreed-to concessions. Yet there is no reason why the U.S. auto companies, for instance had to launch and maintain a ten-year struggle to get minimal investments in Japan, while the Japanese had unequal access to the U.S. market. Likewise, in telecommunications trade, we do not have to unilaterally open our market to foreign competition without a compensating quid pro quo from other nations.

In pursuit of this, the government should use the powers contained in Section 301 of the Trade Act of 1974, as amended in 1984.

A-4. The United States should adhere to broad sector-by-sector negotiations so that industries of like value are treated equally. Thus, we should follow the policies set forth in the Trade Act of 1974. However, within broad sectors, both trade and investment should be considered together since one is closely related to the other with one-third or more U.S. exports, for instance, going to U.S. companies abroad. In addition, where trade and investment are a two-way street, problems in one area usually settle themselves out through earnings in the other area. With some countries in the world today, however, this is not true as they mount an export push while maintaining restrictive policies regarding foreign investments. When developed nations practice this, it is a policy which maximizes total foreign exchange earnings at the sacrifice of trading partners.

When less developed countries engage in these practices, it is viewed in the short term as a stepping stone toward industrialization. However, once those nations emerge into the industrial world, the old policies never seem to change. By adhering to sector negotiations in future meetings with those countries that have newly "graduated" from LDC status, the United States can insist upon changes and hold out the carrot of access to our markets as the benefit to be received.

A-5. The United States must meet foreign export financing subsidies against competing U.S. export products where necessary in order to eliminate these subsidies provided by other nations. The availability of equal financing for U.S. products is a deterrent. While we should never take the first-strike capability in providing outright subsidies to exports, we must always act in defense so that others can be persuaded of the futility of such practices.

A-6. The United States should initiate bilateral and multilateral agreements to phase out trade-distorting subsidies, and where agreement cannot be reached, prompt and effective action must be taken on the subsidized imports. In this regard, we should refrain from using political considerations to balance economic problems.

A-7. There must be respect for international property rights with bilateral or multilateral agreements to insure this. We should not offer a country violating this principle similar automatic safeguards here in the United States. Ever since the establishment of the republic, Congress has been resolute in protecting property rights as they apply to our own jurisdiction. The rights of ownership of patents should be defended because these technical frontiers may prove to be more important to our long-range welfare than physical plants. It is difficult to conceive of any machinery whereby we could impose these values and views on other countries. But we can encourage other countries to hold these values and views by defining in trade legislation the contents of economic negotiations when we give the authority to our government to negotiate with other countries. As one of the conditions of granting future most-favored-nation access to our markets, we should adhere to the principle of protection and/or compensation for industrial property rights. This includes patents, trademarks, proprietary technology or processes.

A-8. Performance requirements that skew international trading relationships must be avoided on investments. The degree of access to the U.S. market should also consider such requirements and they should be part of our negotiating process. Where such requirements involve a local government promise to subsidize production or close local markets to competition, then the performance requirements are no different than subsidies which are actionable under international trade rules.

A-9. Domestic adjustment assistance to firms and workers must be reshaped into a coordinated program to help firms redefine their operations and to help workers retrain for higher level skills. These programs should be combined with unemployment payments where appropriate.

Section B

B-1. Countries with appreciating currencies should be able to use exchange adjusted tariffs and, if necessary, rate equalization charges on financial flows. To maintain a competitive balance in trade flows based on product quality and actual costs when our currency appreciates rapidly from its purchasing power parity trend and creates a balance of payments disequilibrium, the United States should invoke Article XXIII of GATT on nullification and impairment. In our case, a large overvaluation of a currency effectively negates any tariff concessions received. Accordingly, tariff levels should be adjusted upward. Without an unrealistic amount of coordination of fiscal and monetary policies among all industrial nations, it will be impossible for floating exchange rates to self-equilibrate international trade and eliminate arbitrary advantages given those countries whose currencies depreciate by a margin significantly greater than competitive factors would dictate.

The exchange adjustments envisioned here would allow true comparative advantage on the factors of production in a free trade regime. This would allow countries with appreciating and depreciating currencies the opportunity to maintain their respective domestic policies and would not encourage an unbalanced trade position to develop--forcing protectionist quotas or marketing agreements. No country would have to pay for another's excesses, and the use of tariff adjustment rather than quotas would maintain the operation of a market mechanism as a determinant of trade flows without skewing market shares.

A 30 percent currency misalignment, combined with a persistent current account deficit,[1] such as the present one favoring the yen, would give the United States the option to add that amount, or perhaps 80 percent of it, to its basic tariff rates on Japanese imports. When the yen-dollar relationship started to correct (or if the trade and current accounts moved back into first line), the tariff would be lowered back to its original level on a timely basis.

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[1] Where we may have a current account deficit and a large trade surplus, maximum leeway should be used in assessing whether or not to use exchange adjusted tariffs. Also, the current account must be precisely defined so that reinvested earnings and NATO expenditures do not skew our commercial balances.

Floating exchange rates were supposed to achieve an equilibrium in the current account by equalizing the differential inflation between countries. If the exchange rate does not adjust for this difference, then what is proposed here would make the adjustment by affecting the trade account and ultimately the current account.

Thus, no undue trade advantage would be given to those countries whose internal policies are such that they cause a currency depreciation or appreciation, and true comparative advantage on the factors of production could be followed with trade competition based on real economic factors of comparative advantage.

Trade adjusted tariffs might be tried before thought is given to use of charges on capital flows. However, for those who maintain that financial flows must be adjusted also, we should be careful not to institutionalize the use of controls on capital outflows by the depreciating currency country.[1] This does not offer a market response and is akin to quotas in that they reserve the economic rent of the controls for the government and/or businesses of the country already receiving the trade benefits of depreciation. The effect is like the auto quotas which enriched Japanese car companies more than American ones. Instead, if adjustment of financial flows is deemed warranted, then it should be through rate equalization charges levied by the appreciating currency country on the lender (i.e., the foreign supplier of funds) and not the borrower (a U.S. citizen). The market system on allocation and pricing of funds can operate and the initial cost of funds to the borrower would be at home country market rates. The actual adjustment might be set at the difference between real interest rates (possibly allowing an added historical markup such as 2 or 3 percent for the United States) and nominal rates in the U.S. In this way the flow of funds would be guided more by the real economic return to be gained by investing in the U.S. rather than on some extra added profit from very high nominal rates in the U.S.

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[1] See: C. Fred Bergsten in Current Exchange Rate Relationship of the U.S. Dollar and the Japanese Yen, Subcommittee on Trade, House Ways & Means Committee, November 1982, p. 28.

B.-2. The United States should make use of Article XII of GATT on restrictions to safeguard the balance of payments. Where serious balance of payments difficulties arise, we should not be afraid to use internationally recognized tools as corrective measures Special measures to accomplish this should be only temporary rather than cemented in legislation. They should never be used to protect inefficient industries on a long-term basis. The consultations required by Article XII could be helpful in developing some realistic bargaining leverage with other countries and impressing upon them the seriousness of our problems (when they exist) and the resolve that we will do something about it, with or without their help. In the past Article XII has been used by several countries, including those who are reserve currency countries. Britain, whose pound was--up to the 1970s--considered a reserve currency, used Article XII on more than one occasion. France and Japan have also used that article and the U.S. Government should not consider itself "holier than they." Under this article, the United States would be allowed to restrict the quantity or value of merchandise permitted to be imported, and as such should apply a tariff rate quota across the board. The funds obtained from this measure could be used to promote exports or meet foreign subsidies, especially where misalignment of currencies creates an overvalued dollar.

We should further explore in joint consultations under GATT the possibility of the use of Article XII on a bilateral basis. The world has changed since GATT was orginally written and this should be reflected today. Even our constitution, a most sacred document, has been amended during crises to reflect changing times.

Mr. Chairman: I have appreciated the chance to give your Committee my views about what many regard as a critical problem. Some of my suggestions may seem unorthodox, but they highlight my view that we cannot wait for reductions in our domestic budget deficit--as important as that is--to lower our interest rates and dollar exchange rates. For that will probably be too little and too late for major sectors of the American economy.

Thank you for your attention. I would be pleased to respond to any questions the Committee may have.

TABLE I

U. S. NONMILITARY MERCHANDISE TRADE BY AREA, 1965-1983 (Balance of Payments Basis)

	TOTAL			CANADA			W. EUROPE			LATIN AMERICA			JAPAN			OTHER		
	EXP.	IMP.	BAL.	EXP.	IMP.	BAL.	EXP.	IMP.	BAL.	EXP.	IMP.	BAL.	EXP.	IMP.	BAL.	EXP.	IMP.	BAL.
1965	26.5	21.5	5.0	5.7	4.8	0.9	8.9	6.2	2.7	4.2	4.4	- 0.2	2.1	2.4	- 0.3	5.6	3.7	- 1.9
1966	29.3	25.5	3.8	6.7	6.0	0.7	9.6	7.7	1.9	4.7	4.7	0.0	2.3	3.0	- 0.7	6.0	4.1	1.9
1967	30.7	26.9	3.8	7.3	6.9	0.4	9.7	8.1	1.6	4.7	4.7	0.0	2.7	3.0	- 0.3	6.3	4.2	2.1
1968	33.6	33.0	0.6	8.2	8.6	- 0.4	10.5	10.2	0.3	5.3	5.1	0.2	3.0	4.1	- 1.1	6.6	5.0	1.6
1969	36.4	35.8	0.6	9.1	9.9	- 0.8	11.6	10.2	1.4	5.5	5.2	0.3	3.5	4.9	- 1.4	6.7	5.6	1.1
1970	42.5	40.0	2.5	9.5	10.7	- 1.2	14.2	11.3	2.9	6.5	5.9	0.6	4.7	5.9	- 1.2	7.6	6.2	1.4
1971	43.3	45.6	- 2.3	10.9	12.2	- 1.3	13.6	12.8	0.8	6.5	6.1	0.4	4.1	7.3	- 3.2	8.2	7.2	1.0
1972	49.4	55.8	- 6.4	13.1	14.5	- 1.4	15.0	15.7	- 0.7	7.2	7.1	0.1	5.0	9.1	- 4.1	9.1	9.4	- 0.3
1973	71.4	70.5	0.9	16.7	17.7	- 1.0	21.2	19.8	1.4	10.0	9.6	0.4	8.4	9.7	- 1.3	15.1	13.7	1.4
1974	98.3	103.8	- 5.5	21.8	22.6	- 0.8	28.2	24.3	3.9	15.8	18.7	- 2.9	10.7	12.4	- 1.7	21.8	25.8	- 4.0
1975	107.1	98.2	8.9	25.5	21.9	3.6	29.9	20.8	9.1	17.1	16.2	0.9	9.6	11.3	- 1.7	27.0	28.0	- 1.0
1976	114.7	124.2	- 9.5	26.3	26.7	- 0.4	31.9	23.0	8.9	16.9	17.2	- 0.3	10.2	15.5	- 5.3	29.4	41.8	-12.4
1977	120.8	151.9	- 31.1	28.5	29.9	- 1.4	34.1	28.2	5.9	17.9	21.2	- 3.3	10.6	18.6	- 8.0	29.7	54.0	-24.3
1978	142.1	176.0	- 33.9	31.2	33.8	- 2.6	39.5	36.6	2.9	22.0	23.0	- 1.0	13.0	24.5	-11.5	36.4	58.1	-21.7
1979	184.5	212.0	- 27.5	38.7	39.2	- 0.5	54.2	41.8	12.4	28.6	30.5	- 1.9	17.6	26.3	- 8.7	45.4	74.2	-28.8
1980	224.2	249.8	- 25.6	41.6	42.9	- 1.3	67.6	47.3	20.3	38.8	37.5	1.3	20.8	31.2	-10.4	55.4	90.9	-35.5
1981	237.0	265.1	- 28.1	46.0	48.3	- 2.3	65.1	52.9	12.2	42.8	39.1	3.7	21.8	37.6	-15.8	61.3	87.2	-25.9
1982	211.2	247.6	- 36.4	39.3	48.5	- 9.2	59.7	52.9	6.8	33.2	38.6	- 5.4	20.7	37.7	-17.0	58.3	69.9	-11.6
1983	200.3	261.3	- 61.0	43.8	54.4	-10.6	54.9	53.9	1.0	25.6	41.9	-16.3	21.7	41.3	-19.6	54.3	69.8	-15.5
1984	220.0	327.6	-107.6	53.1	68.7	-15.6	57.1	71.0	-13.9	29.8	48.0	-18.2	23.3	57.3	-34.0	56.7	82.6	-25.9

Source: Survey of Current Business, U. S. Department of Commerce, various issues.

TABLE II (a)
U. S. TRADE BY MAJOR CATEGORY

(millions of $)

	FOOD & LIVE ANIMALS			BEVERAGES & TOBACCO		
	EX.	IM.	BAL.	EX.	IM.	BAL.
1957	2,388	3,052	- 664	442	313	129
1958	2,240	3,208	- 968	448	343	105
1959	2,405	3,173	- 768	447	407	40
1960	2,662	2,996	- 334	483	396	87
1961	2,916	3,018	- 102	506	437	69
1962	3,179	3,243	- 64	498	431	67
1963	3,565	3,401	164	531	462	69
1964	4,076	3,487	589	554	535	19
1965	4,003	3,460	543	517	553	- 36
1966	4,562	3,948	614	624	642	- 18
1967	4,061	4,003	58	649	698	- 49
1968	3,890	4,577	- 687	702	786	- 84
1969	3,733	4,531	- 798	714	778	- 64
1970	4,356	5,375	-1,019	702	855	- 153
1971	4,367	5,529	-1,162	709	876	- 167
1972	5,661	6,370	- 709	908	1,009	- 101
1973	11,930	8,015	3,915	1,008	1,221	- 213
1974	13,986	9,386	4,600	1,247	1,322	- 75
1975	15,484	8,503	6,981	1,308	1,420	- 112
1976	15,710	10,267	5,443	1,524	1,624	- 100
1977	14,116	12,558	1,558	1,847	1,669	178
1978	18,311	13,522	4,789	2,293	2,221	72
1979	22,245	15,170	7,075	2,337	2,565	- 228
1980	27,744	15,763	11,981	2,663	2,771	- 108
1981	30,291	15,238	15,053	2,915	3,138	- 223
1982	23,950	14,453	9,497	3,026	3,364	- 338
1983	24,166	15,412	8,754	2,813	3,408	- 595
1984	24,463	17,973	6,490	2,849	3,653	- 804

Source: *Overseas Business Reports* and *Survey of Current Business*, U. S. Dept. of Commerce, various issues.

TABLE II (b)
U. S. TRADE BY MAJOR CATEGORY
(millions of $)

	ANIMAL & VEGETABLE OIL & FATS			CHEMICALS		
	EX.	IM.	BAL.	EX.	IM.	BAL.
1957	335	102	233	1,376	668	808
1958	272	98	174	1,425	789	636
1959	320	104	216	1,558	868	690
1960	307	95	212	1,805	821	984
1961	289	93	196	1,816	738	1,078
1962	314	98	215	1,883	772	1,111
1963	320	105	215	1,994	715	1,279
1964	414	119	295	2,364	702	1,662
1965	472	116	356	2,402	769	1,633
1966	357	146	211	2,675	955	1,720
1967	338	122	216	2,802	958	1,844
1968	274	158	116	3,287	1,129	2,158
1969	308	137	171	3,383	1,228	2,155
1970	493	160	363	3,826	1,450	2,376
1971	615	172	443	3,836	1,612	2,224
1972	508	180	328	4,133	2,015	2,118
1973	684	259	425	5,749	2,463	3,286
1974	1,423	544	879	8,819	4,018	4,801
1975	944	554	390	8,691	3,696	4,995
1976	978	464	514	9,959	4,772	5,187
1977	1,309	531	778	10,812	4,970	5,842
1978	1,521	511	1,010	12,623	6,430	6,193
1979	1,845	740	1,105	17,306	7,479	9,827
1980	1,946	533	1,413	20,740	8,583	12,157
1981	1,750	480	1,270	21,187	9,446	11,741
1982	1,541	406	1,135	19,891	9,494	10,397
1983	1,459	495	964	19,751	10,779	8,972
1984	1,922	696	1,226	22,336	13,697	8,639

Source: Overseas Business Reports and Survey of Current Business, U. S. Dept. of Commerce, various issues.

TABLE II (c)
U. S. TRADE BY MAJOR CATEGORY
(millions of $)

	CRUDE MATERIALS (INEDIBLE) OTHER THAN FUELS			MINERAL FUELS AND RELATED MATERIALS		
	EX.	IM.	BAL.	EX.	IM.	BAL.
1957	2,533	2,766	- 233	1,814	1,556	258
1958	1,708	2,331	- 623	1,071	1,631	- 560
1959	1,823	2,907	- 1,084	853	1,568	- 715
1960	2,777	2,711	66	814	1,574	- 760
1961	2,765	2,485	280	763	1,725	- 962
1962	2,211	2,668	- 457	799	1,874	- 1,075
1963	2,476	2,673	- 197	945	1,914	- 969
1964	2,978	2,880	98	953	2,030	- 1,077
1965	2,856	3,103	- 247	947	2,221	- 1,274
1966	3,071	3,310	- 239	976	2,262	- 1,286
1967	3,284	2,997	287	1,104	2,248	- 1.144
1968	3,541	3,346	195	1,050	2,527	- 1.477
1969	3,569	3,460	109	1,130	2,794	- 1,664
1970	4,605	3,307	1,298	1,595	3,075	- 1.480
1971	4,329	3,382	947	1,497	3,715	- 2,218
1972	5.030	3,860	1,170	1,552	4,799	- 3,247
1973	8,380	5,014	3.366	1,671	8,173	- 6,502
1974	10,934	6,066	4,868	3,444	25,454	-22,010
1975	9,784	5,566	4,218	4,470	26,476	-22,006
1976	10,891	7,014	3,877	4,226	33,996	-29,770
1977	13,086	8,464	4,622	4,184	47,153	-42,969
1978	15,555	9,294	6,261	3,881	44,763	-40,882
1979	20,755	10,653	10,102	5,616	63,376	-57,460
1980	23,791	10,496	13.295	7,982	82,924	-74,942
1981	20,992	11,193	9,799	10,279	81,417	-71,138
1982	19,248	8,589	10,659	12,729	65,409	-52,680
1983	18,596	9,590	9,006	9.500	57,952	-48,352
1984	20,249	11,082	9,167	9,310	60,980	-51,670

Source: Overseas Business Reports and Survey of Current Business, U. S. Dept. of Commerce, various issues.

TABLE II (d)
U. S. TRADE BY MAJOR CATEGORY

(millions of $)

	MACHINERY			TRANSPORT EQUIPMENT		
	EX.	IM.	BAL.	EX.	IM.	BAL.
1957	4,215	431	3,784	2,654	431	2,223
1958	3,894	483	3,411	2,496	670	1,826
1959	3,883	676	3,207	2,193	957	1,236
1960	4,308	724	3,584	2,704	742	1,962
1961	4,761	789	3,972	2,569	575	1,994
1962	5,217	954	4,263	2,840	720	2,120
1963	5,483	1,054	4,429	2,785	764	2,021
1964	6,525	1,314	5,211	2,844	902	1,942
1965	6,934	1,800	5,134	3,214	1,148	2,066
1966	7,678	2,688	4,990	3,478	2,135	1,343
1967	8,280	3,099	5,181	4,294	2,695	1,599
1968	8,844	3,772	5,072	5,603	4,215	1,389
1969	10,137	4,571	5,566	6,266	5,192	1,074
1970	11,685	5,375	6,310	6,197	5,798	399
1971	11,839	6,059	5,780	7,621	7,814	- 193
1972	13,566	7,916	5,650	7,951	9,504	- 1,553
1973	17,588	10,750	7,438	10,281	10,926	- 645
1974	24,318	11,811	12,507	13,871	12,251	1,620
1975	29,215	11,970	17,245	16,452	11,487	4,965
1976	32,113	15,446	16,667	17,388	14,378	3,010
1977	32,630	18,836	13,794	17,619	17,571	48
1978	38,105	24,752	13,353	21,163	22,838	- 1,675
1979	45,914	28,530	17,384	24,577	25,148	- 571
1980	57,263	32,286	24,977	27,366	28,260	- 894
1981	62,946	38,212	24,734	32,791	31,415	1,376
1982	59,324	39,457	19,867	27,824	33,863	- 6,039
1983	54,309	46,975	7,334	28,269	39,156	- 10,887
1984	60,318	68,345	- 8,027	29,655	50,802	- 21,147

Source: Overseas Business Reports and Survey of Current Business, U. S. Dept. of Commerce, various issues.

TABLE II (e)
U. S TRADE BY MAJOR CATEGORY

(millions of $)

	MANUFACTURED GOODS			OTHER TRANSACTIONS		
	EX.	IM.	BAL.	EX.	IM.	BAL.
1957	4,349	3,542	807	475	362	113
1958	3,731	3,342	389	466	325	141
1959	3,537	4,589	- 1,052	431	380	51
1960	4,076	4,559	- 483	450	401	49
1961	3,891	4,421	- 530	476	435	41
1962	3,972	5,180	- 1,208	518	440	78
1963	4,349	5,532	- 1,183	615	517	98
1964	4,795	6,188	- 1,393	794	591	203
1965	4,890	7,528	- 2,638	954	730	224
1966	5,388	8,668	- 3,280	1,187	866	321
1967	5,468	9,004	- 3,536	959	1,065	- 96
1968	6,084	11,208	- 5,424	924	1,028	- 104
1969	7,000	12,020	- 5,020	1,224	1,332	- 108
1970	7,636	13,285	- 5,649	1,496	1,274	222
1971	7,147	14,929	- 7,782	1,531	1,476	55
1972	8,094	18,332	-10,238	1,560	1,598	- 38
1973	11,113	21,461	-10,348	1,842	1,794	48
1974	16,515	27,145	-10,630	2,587	2,256	331
1975	16,592	23,927	- 7,335	3,162	2,518	644
1976	17,781	30,180	-12,399	2,749	2,538	211
1977	19,091	35,176	-16,085	4,314	3,358	956
1978	22,644	46,296	-23,652	5,030	4,018	1,012
1979	28,879	51,070	-22,191	9,103	4,905	4,198
1980	38,602	55,901	-17,299	8,496	7,183	1,313
1981	37,379	63,471	-26,092	8,389	7,296	1,093

	MANUFACTURED GOODS & OTHER TRANSACTIONS		
	EXP.	IMP.	BAL.
1982	39,543	68,917	-29,374
1983	37,106	74,281	-37,175
1984	40,932	98,588	-57,656

Source: Overseas Business Reports and Survey of Current Business, U. S. Dept. of Commerce, various issues.

TABLE III

U. S. TRADE BALANCE, OFFICIAL CURRENT ACCOUNT AND CURRENT ACCOUNT ON ACTUAL TRANSACTIONS[1], OVERALL, 1960-1970, (in millions of $)

	1960	1961	1962	1963	1964	1965	1966	1967	1968	1969	1970
U.S. Overall Trade Balance	4,892	5,571	4,521	5,224	6,801	4,951	3,817	3,800	635	607	2,603
Official Current Account	1,732	3,005	2,404	3,143	5,718	4,251	1,582	1,215	-1,374	-2,017	-356
Overstatement of[2] Net Reinvested Earnings	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA
Current Account on Actual Transactions	1,732	3,005	2,404	3,143	5,718	4,251	1,582	1,215	-1,374	-2,017	- 356

(footnotes attached)

TABLE III

U. S. TRADE BALANCE, OFFICIAL CURRENT ACCOUNT AND CURRENT ACCOUNT ON ACTUAL TRANSACTIONS[1], OVERALL, 1971-1984, (in millions of $)

	1971	1972	1973	1974	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984
U. S. Overall Trade Balance	-2,260	-6,416	+ 911	-5,505	+ 8,903	-9,483	-31,091	-33,966	-27,555	-25,512	-28,001	-36,469	-61,055	-107,600
Official Current Account	-1,433	-5,795	+7,140	+1,962	+18,116	+4,207	-14,511	-15,446	- 964	+ 1,898	+ 6,294	- 9,199	-41,563	-101,647
Overstatement of Net Reinvested Earnings[2]	(+2,635)	(+3,963)	(+7,248)	(+6,712)	(+ 6,859)	(+6,037)	(+ 4,810)	(+ 8,760)	(+15,010)	(+10,850)	(+ 8,879)	(+ 7,665)	(+ 7,733)	(+ 8,249)
Current Account on Actual Transactions	-4,068	-9,758	- 108	-4,750	+11,257	-1,830	-19,321	-24,206	-15,974	- 8,952	- 2,585	-16,864	-49,296	-109,896

(footnotes attached)

TABLE III

Footnotes:

1/ Current Account on Actual Transactions represents the balance of actual imports and exports of goods and services. It is the current expenditure of dollars on all imports minus the earning of foreign exchange from all exports and includes the balance on goods and services and unilateral transfers but excludes accounting gimmicks as outlined in footnote 2.

2/ Reinvested earnings of American companies abroad are included in the government current account figures *as if they were an inflow of funds*, thus inflating our exports of goods and services. These monies are not an actual inflow of funds, of course, since they are earned abroad, taxed abroad and used abroad. In the U.S. Official Capital Account the exact same "inflow" is subtracted as an outflow so the total effect on our complete payments accounts is zero. The reverse of the above is true for reinvested earnings of foreign companies here in the United States. The figure on this line represents the difference between the fictitious export and import of these funds. A (+) represents the net amount that must be subtracted from the official current account; a (-) represents the amount that must be added.

NA - Not applicable. In earlier years, reinvested earnings were never included in the current account. The change to include them on the plus side of the current account and below the line on the negative side of the capital account occurred in 1977. U.S. accounts *since then* have been restated back to 1971 and have overstated the actual balance in foreign exchange terms.

SOURCE: *Survey of Current Business*, U.S. Department of Commerce, various issues.

TABLE IV

MANUFACTURING PRODUCTIVITY -- OUTPUT/HOUR
(annual percentage change)

YEAR	U.S.	JAPAN	FRANCE	W. GERMANY	U.K.
1960-83	2.6	9.1	5.8	5.0	3.5
1960-73	3.0	10.7	6.7	5.7	4.4
1973-83	1.9	7.3	4.6	3.3	1.9
1980	0.2	9.5	1.5	1.4	-1.0
1981	3.1	5.5	2.6	1.8	5.9
1982	2.1	8.1	5.6	1.2	3.9
1983	4.3	5.0	5.9	4.7	6.6
1984	4.8 est.				

Source: Bureau of Labor Statistics

OVERALL U.S. PRODUCTIIVITY -- OUTPUT/HOUR
(annual percentage change)

1965	3.0
1966	3.5
1967	2.1
1968	2.7
1969	0.0
1970	0.8
1971	3.6
1972	3.5
1973	2.6
1974	-2.4
1975	2.2
1976	3.3
1977	2.4
1978	0.5
1979	-1.2
1980	-0.5
1981	1.9
1982	0.2
1983	2.7
1984	3.2

Source: CEA _Economic Indicators_

TABLE V (a)

U.S. TRADE AND CURRENT ACCOUNT[1] BALANCES BY SELECTED AREAS
(millions of $)

Year	WESTERN EUROPE		LATIN AMERICA AND OTHER WESTERN HEMISPHERE		ASIA AND AFRICA[2]	
	Trade	Current	Trade	Current	Trade	Current
1960	2,549	232	-194	276	794	- 34
1961	2,787	795	22	615	1,038	124
1962	2,602	833	-316	298	1,413	719
1963	2,881	1,057	-398	215	1,649	1,059
1964	3,378	1,866	74	806	1,682	1,215
1965	2,686	1,078	-122	586	1,400	938
1966	1,914	179	38	1,006	1,590	240
1967	1,581	51	18	1,063	1,826	218
1968	342	-1,465	153	1,493	1,256	185
1969	1,402	-1,230	324	1,312	745	- 12
1970	2,886	-1,092	603	1,420	961	451
1971	779	-2,238	346	1,274	400	-205
1972	-667	-5,037	162	713	-1,033	-1,154
1973	1,457	-4,169	316	1,600	- 398	1,625
1974	3,897	-1,000	-2,838	-853	-6,684	-6,358
1975	9,120	5,690	931	4,604	-4,922	-1,721
1976	8,880	6,646	-337	3,951	-16,755	-11,879
1977	5,868	4,210	-3,243	1,900	-26,486	-19,981
1978	2,928	1,627	-1,008	5,692	-23,181	-16,530
1979	12,351	13,836	-1,980	6,366	-31,527	-24,531
1980	20,348	19,102	1,320	12,347	-37,520	-33,386
1981	12,235	9,656	3,705	20,100	-32,260	-26,085
1982	6,793	3,101	-5,407	8,021	-16,888	-11,750
1983	981	-6,391	-16,286	-8,163	-18,453	-14,088
1984	-13,943	-27,904	-18,198	-13,425	-30,182	-27,482

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[1] This includes reinvested earnings which are not really inflows.

[2] Excluding Japan and South Africa.

Source: Survey of Current Business, various issues

TABLE V (b)

U.S. TRADE AND CURRENT ACCOUNT[1] BALANCES WITH SELECTED COUNTRIES

(in millions of $)

Year	CANADA		UNITED KINGDOM	
	Trade	Current	Trade	Current
1960	861	1,054	466	141
1961	625	965	294	85
1962	393	685	147	-74
1963	388	596	173	-31
1964	593	1,177	468	360
1965	642	1,401	216	92
1966	801	1,753	-24	-171
1967	448	1,053	162	166
1968	-442	373	-86	-248
1969	-812	44	-42	-758
1970	-1,645	-580	329	-484
1971	-1,760	-453	-73	-779
1972	-1,972	-426	-214	-975
1973	-984	676	232	-507
1974	-550	1,541	583	-240
1975	1,827	6,673	1,144	258
1976	-139	5,814	941	- 1
1977	-1,112	4,938	900	754
1978	-2,323	4,704	802	893
1979	- 330	8,720	2,677	6,316
1980	-1,277	7,315	2,970	5,602
1981	-2,242	7,174	-263	3,859
1982	-9,323	98	-2,352	-841
1983	-10,546	551	-2,008	-8,701
1984	-15,534	-5,071	-2,297	

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[1] This includes reinvested earnings which are not really inflows.

Source: Survey of Current Business, various issues.

TABLE V (c)

U.S. TRADE AND CURRENT ACCOUNT[1] BALANCES WITH SELECTED COUNTRIES
(millions of $)

	GERMANY		FRANCE		MEXICO	
	Trade	Current	Trade	Current	Trade	Current
1968	-1,085	-1,679	233	229	468	390
1969	- 622	-1,299	386	303	422	391
1970	- 506	-1,270	596	439	483	407
1971	1,121	-1,897	316	206	357	186
1972	-1,546	-3,101	251	103	353	32
1973	-1,841	-3,860	581	333	655	338
1974	-1,615	-3,301	670	522	1,469	1,335
1975	- 306	-1,684	962	1,164	2,107	2,459
1976	- 177	- 620	1,031	1,098	1,412	1,223
1977	-1,399	-2,576	490	674	140	- 52
1978	-2,766	-3,918	190	684	595	644
1979	-2,259	-4,236	850	1,110	1,130	1,785
1980	- 243	-3,167	2,277	2,721	2,647	4,790
1981	- 887	-4,192	1,592	1,145	4,440	8,807
1982	-2,689	-5,866	1,661	1,827	-3,820	-1,956
1983	-4,284	-9,606	-39	-172	-7,693	-6,677
1984	-7,945		-1,925		-6,002	

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[1] This includes reinvested earnings which are not really inflows.

Source: Survey of Current Business, various issues.

TABLE VI

U.S. TRADE AND OFFICIAL CURRENT ACCOUNT BALANCES WITH JAPAN, 1960-1984

(in millions of $)

Year	U.S. Trade Balance with Japan	Current[1] Account with Japan
1960	225	-108
1961	710	454
1962	180	- 52
1963	320	105
1964	200	86
1965	-388	-505
1966	-634	-915
1967	-345	-587
1968	-1,120	-1,384
1969	-1,416	-1,777
1970	-1,244	-1,541
1971	-3,225	-3,475
1972	-4,113	-4,821
1973	-1,309	-1,463
1974	-1,690	- 944
1975	-1,690	-1,220
1976	-5,335	-5,405
1977	-7,999	-8,126
1978	-11,581	-11,791
1979	-8,632	-8,746
1980	-10,411	-8,917
1981	-15,882	-13,923
1982	-16,991	-15,478
1983	-19,630	-18,332
1984	-34,024	-35,176

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[1] This includes reinvested earnings which are not really inflows.

Source: Survey of Current Business, various issues.

Chairman **LaFalce**. Before I begin with the question and answer period, it seemed to me that a number of you made some very provocative statements, and I wonder if any panelists view the statements of others as provocative. If so, would you care to join issue with any of the statements made by any of the other panelists?

Mr. Fox.

Mr. Fox. I think it's your question, sir, but I didn't hear a constructive suggestion from the U.S. Government's representative. I had the idea that they were walking down a dark corridor and had pretty good reason to believe that they wouldn't be mugged before they got to the end of it, but I didn't hear why.

Chairman **LaFalce**. All right; good.

Any other comments that any others would like to make?

[No response.]

Chairman **LaFalce**. All right. Let me begin the questioning, then.

Well, first of all, if we would have someone here such as Arthur Laffer, I think he might say, "Oh, we really don't have that much of a problem. Unemployment has come down, the increase in our GNP has been witnessed—at least for the past 2 years or so—and this trade deficit is not really that much of a problem."

Is there general agreement that the trade deficit really is a serious problem? I don't think we have to ask Mr. Heckert and Mr. Fox and Mr. Danielian that question. But Mr. Feketekuty, within the administration, is there a realization that the trade deficit is a problem?

Mr. **Feketekuty**. I think there's a growing perception that it is a problem.

Chairman **LaFalce**. A growing perception. You mean the administration is not yet at the point where they view the trade deficit as a problem; or they viewed it as a problem before and now they view it as even a larger problem?

Mr. **Feketekuty**. Well, certainly Ambassador Brock has been convinced it is a problem. I'm sure you've read about the Secretary of State's speech in Princeton in which he expressed a view that it was a problem. But I'm not sure that I can speak for all the other elements of the Government. But I do think that there is a growing consensus within the Government that it is a problem that needs to be tackled.

Chairman **LaFalce**. Well, as I hear President Reagan speaking, he seems to be saying that our problems are due to our strengths. Now, that might sound as if it's contradictory, but I'm only trying to characterize statements that the President has made.

He went before the New York Stock Exchange a few weeks ago and boasted of the strength of our dollar. All you gentlemen seem to think that the strength of our dollar has gotten out of hand so that it's an overvalued dollar—noncompetitive dollar—and I don't know that that is the position of the President. It may be the position of the administration, but I'm not sure that it's the position of the President.

What is—do you know——

Mr. **Feketekuty**. Mr. Chairman, I would say that you can certainly take the position the President took, which is that the strength of the dollar is a sign of the strength of the American economy. The reason that the dollar is high is because we've been growing much faster than the rest of the world. We've not had the kind of debt problems that other people have had.

Chairman **LaFalce**. How is it that we have been able to grow faster than other countries? How is it that we've been able to have such tremendous increases in GNP when we have been having such increases in the trade deficit?

Mr. **Feketekuty**. Well, the question is, what comes first. What's the chicken; what's the egg?

If you see the trade deficit as a result of the faster growth, then it's not surprising at all. You can then see how eventually the deficit will slow down the growth, but it doesn't do away with the fact that the initial fast growth rate certainly contributed to the large increase in the deficit.

Chairman **LaFalce**. But the trade deficit will impede a continuation of good GNP performance; is that your position?

Mr. **Feketekuty**. It certainly would be my view.

Chairman **LaFalce**. All right, fine. We would agree there.

Anybody want to comment on any of the comments that——

Mr. **Feketekuty**. Mr. Chairman, I think we should be careful to make a distinction between the overall average effect, the macro effect, on the economy and the sectoral effects. You can have a situation where we could be running close to full capacity on average and still have certain sectors which were in difficulty. I think that's more likely the case than the economy as a whole suffering.

If you look at capacity utilization in the economy, it's not bad compared to past performance. I mean, we're overall manufacturing now up to 82 percent.

Chairman **LaFalce**. Where are you in your notes here?

Mr. **Feketekuty**. Table 2 on page 6: 82 percent of capacity utilization, traditionally, has not been a bad situation. I think the problem comes when you see the differentials between the various sectors. That's where the problems come in. And I think that's where in the long run——

Chairman **LaFalce**. But I guess this does raise a question. Does everybody agree with him that, in the aggregate, the capacity utilization right now is not all that bad, that it's simply sectors. That's one point. But then if you should agree with him—if you disagree with him, let me know—but if you should agree with him, isn't that still a serious problem because of the virtual decimation therefore of certain sectors, particularly if they're key sectors. And isn't it important that we look at the relative merit of sectors to see which sectors are increasing and which sectors have been decreasing precipitously, because it might reveal a transformation of American industrial-societal trends?

Mr. Heckert?

Mr. **Heckert**. Mr. Chairman, may I respond to that in several different ways?

First of all, there obviously is a sectoral dislocation but it's not just that. In our industry, the period from 1979 to 1984 was unprecedented physical volumes of production. The goods we produced did not increase in a 5-year period. I just know of no time——

Chairman **LaFalce**. What was that 5-year period?

Mr. **Heckert**. 1979—the summer of 1979 until, roughly, the end of 1984. Now, these are obviously averages; they're aggregates of all types of goods we make. But there has been no recovery period in the last three decades when we failed to come closer to capacity than we did in this one. We peaked at something like 82 or 83 percent and in the past we've always—in that part of the cycle—gone up to certainly 90 percent or between 85 and 90 percent sales to capacity. It was from our standpoint——

Chairman **LaFalce**. What about overall levels of utilization in peak recovery periods such as this? Have they generally surpassed the——

Mr. **Heckert**. Absolutely. They've typically, as I said, gone——

Chairman **LaFalce**. Not just for you. I'm talking about in the aggregate.

Mr. **Heckert**. I think in the aggregate they have. I haven't seen any numbers recently but I would expect that——

Chairman **LaFalce**. Mr. Fox or Mr. Danielian?

Mr. **Heckert** [continuing]. Part of the recovery you would expect to get close to 90 percent.

Chairman **LaFalce**. You have that, Mr. Fox?

Mr. **Fox**. On page 6 of my prepared statement, we have the figures using Federal Reserve index. It's now at about 82 as Geza Feketekuty indicated and, normally, at the peak of the business cycle it is 90 or above. So what Mr. Heckert says is correct.

Chairman **LaFalce**. All right. Well, then, Mr. Feketekuty—I'm having a problem as I usually do—these gentlemen are disagreeing with your basic premise that everything is OK in the aggregate, because they're basically saying that at the peak of the recovery, you should have higher capacity utilization.

Mr. **Feketekuty**. But who says we're at the peak? We're recovering. Last year we had the fastest growth rate since 1951. We're clearly on the growth path. We're continuing on the growth path. I would say at a 90 percent capacity utilization rate we would expect to get into significant inflationary problems.

But the point I would make is clearly we're not at the peak at this point. We're still in the upward swing.

Chairman **LaFalce**. What's the general consensus amongst economists as to whether or not we're still in the upswing or not? Mr. Fox? Mr. Danielian?

Mr. **Fox**. Well, I'll give you an opinion that has a little bit more prestige than my own. We might quote Paul Volcker who just 10 days ago said that the manufactured goods sector, the agricultural sector, and the mining sector, are really in trouble. And he referred to that—I have the reference in the Wall Street Journal, I'll supply it for the record, if you would like. I don't think I have anything to add to what he said.

Mr. **Danielian**. Mr. Chairman, this view of looking at the overall, ignored shifts in the various sectors of the economy. We are growing at a fast pace on borrowed funds and the borrowed funds were from abroad. And the more you borrow from abroad, the more the dollar goes up. And the more the dollar goes up, the more dislocation you have in industry.

Cargill, the grain company, last year was right on the verge of importing foreign grain into the United States to sell here. Now, that's ludicrous. The United States has always been the lowest cost producer of grains in the world. Yet here, because of the dollar, you have a dislocation—you have that continuing on and on. It's a cycle that's going to have to be broken.

Chairman LaFalce. Well, the reason I'm trying to focus in on this is because so often over the past 4 years, I've been unable to come to basic definition of situations with the administration.

For years I've been claiming that we have an industrial competitiveness problem. If you read the report of the Council of Economic Advisers, you would have heard them say we did not have an industrial competitiveness problem. The recent Young Commission Report came out and said, by God, of course we do; of course, we do.

And then there are different causes for concern—both macroeconomic causes and microeconomic causes. For the most part in the past 2 years, I focused in on microeconomic while always saying that macroeconomic causes were the principal cause of our competitive problems. People didn't hear that portion of it.

In any event, I do have a million more questions, but I will defer some of them till later.

Mr. Vento. Thank you, Mr. Chairman. I think it's a very important question, and I have some questions for Mr. Feketekuty—is it? It's a great name.

In looking at the representation, Mr. Feketekuty, I'm looking at table 1, where you point out the U.S. assets abroad that we have invested, and then in looking at the foreign assets in the United States, and I'm wondering if, in terms of factoring it out, do you have—does that include, for instance, foreign debt? I mean, that we have? It does include foreign debt.

So, clearly, the greatest assets abroad would be money that we borrowed to, I guess, Third World countries. Is that right? And to others?

Mr. Feketekuty. That we lent—that's right, sir.

Mr. Vento. So, I mean, that makes up the greatest portion of that activity, is recycling OPEC money, I guess, which is—then I guess foreign assets to the United States, does that represent debt here? Is that what that represents? Or, does it represent investment? Or, is it only debt?

Mr. Feketekuty. It represents both financial and real assets.

Mr. Vento. So I think that the question of whether or not the paper they're holding on us is relatively better than the paper we might be holding on them, which, I think, I probably would rather have the U.S. bonds than the Argentine or Mexican bonds.

Mr. Feketekuty. It's a fair point.

Mr. Vento. The point that you make on page 3, you say that the real problem is not whether the United States is a creditor or a debtor, we have been both in the past.

When was the most recent time that we were a debtor Nation? Do you know?

Mr. Feketekuty. Prior to 1917.

Mr. Vento. Prior to 1917. So I think that the impression that I guess that I don't think is inadvertently given here is that we have been a debtor Nation, that this is cyclical and that there's nothing to worry about; that really it's a very serious change in terms of our economy on an international basis, is it not?

I mean, really, I think that the problem is very serious and I am concerned, as I'm sure all of us are, that we are able to deal with this particular issue. And I am pleased in recent weeks to see a change in the administration—I mean, the announcement by Secretary of Treasury Baker on Saturday, I think, is encouraging. But, nevertheless, I think it falls far short of the sort of engaging type of negotiations that might be necessary because I do think it's that.

When we look at our deficit, our annual deficit in terms of our Federal budget, of course, a great number of concerns arise. And I wouldn't want to diminish or minimize those because I think they're very serious.

But as a percentage of our gross national product compared, for instance, with the national debt in the Japanese Government or other governments, it still is, I suppose, considered manageable. I think it's a special problem for us because of the way that it's ballooned, almost tripling in size now from what it was in something like 1980.

I don't want to get into the political discussions of that today. I don't think that that's helpful to the discussion that we're facing. And I don't—when there's a suggestion that that has to be resolved in order to deal with the trade issue, I guess I have some disagreements because I don't think that fundamentally that that in and of itself is going to resolve that problem. It is true that we have to raise more money internationally, but isn't it also a function of our monetary policy, of our policy with regard to the value of the dollar, is there really—in other words, how can we separate these?

Is it possible that we can carry on negotiations and change the value of the dollar somehow in the absence of the interest rates? Because interest rates certainly are high in any case relatively in this country. I mean, they are sort of tied together. It's a triangle. One thing, we're buying foreign goods that cost less. And if the value of the dollar were different and as it changed, there'll be a big surge of inflation that will come from the importation of those goods because markets will not change immediately.

Second, we have to continue to attract money with regard to our deficit, at least for the near future. I don't think anyone is suggesting that we're going to be able to solve that overnight. I don't think that we will at the very least. I mean, what do we have to do?

Doesn't there almost by necessity have to be a monetary response to this particular problem? Wouldn't you agree?

Mr. **Feketekuty**. Yes, but you can't disentangle it from the budget issue. I think, as you said yourself, sir, ultimately it is a question of the resources that we generate in this economy versus the demand for those resources. And as I tried to indicate in my testimony, there's a large gap between savings and investments.

The very large spurt of investments in the United States plus the demand for savings by the Government far exceeds the savings that are domestically generated.

Mr. **Vento**. Well, the problem is that foreign debt has also grown. And you indicate that we're investing—in your own table, you indicate that, I mean, it isn't that we're operating in a vacuum here, but foreign debt has also grown and has grown at a rather substantial margin.

So, I mean, in other words, I think that there are some constants here. In other words, irrespective of whether or not whatever plan is adopted with regard to the budget, we're going to have $175 billion-plus deficit in 1986, unless something happens that nobody is now expecting, unless economic growth has a far better projection, unless there is some big increase in tax revenues or some curtailment—substantial curtailment—of other programs that are not now envisioned by anyone, as far as I know, that's a constant.

So the point is that why has the dollar value risen 60 to 70 percent when we've had an increase in debt? Other nations have also had that, relatively.

So I don't understand. I mean, the thing is it seems to me it has to be a monetary policy type of answer in terms of renegotiating some of the dollars down.

Mr. Danielian, you have expressed some concern about that, and maybe it would be best to have you respond to that if I'm on the wrong track, or if you want to comment on my inquiry.

Mr. **Danielian**. Well, the situation is that we have had large growth and it is on borrowed funds. And, as I said, it creates a cycle. It has increased the value of the dollar and hurts our exports.

But, I think, you've got to separate this issue. Also the budget deficit is extremely important, and you really are going to aggravate the situation in our international accounts as long as you continue to have high budget deficits.

However, we have had problems in our international accounts on the current accounts since 1968. So this is not new. And we've had situations where the dollar has depreciated by 30 percent with little help. In going back to our library, I discovered hearings by the Joint Economic Committee in 1978 entitled "The Dollar Rescue Operations and Their Domestic Implications."

You know, it was a crisis time in 1978, when the dollar was depreciating by 30 percent. Although our trade responded in some respects, we still had huge current account deficits of $28 to $30 billion.

So while the situation transcends the deficit, it goes in parallel. And because we are borrowing so much money from abroad to increase our domestic expansion here and fund the Government deficit, it is having an aggravating effect, no question about it. Absolutely.

But, at the same time, I think you've got other problems that you have to settle.

Chairman **LaFalce**. One last followup?

Mr. **Fox**. I would just comment I think Mr. Danielian's sense of history is correct, but I think that there has been a discontinuity in the scope. We have had a current account deficit over a prolonged period of time and a trade deficit at certain times. But I think the level of the current account deficit now is totally beyond what we've had before and is potentially destabilizing, not only to our own economy but to the economy of the rest of the world.

Let me give you one figure. This is an official figure of the Department of Commerce. Last year, interest payments to foreigners on Treasury debt was $19 billion. Now we know this year it's probably going to be double that. We are going to have to pay interest and doubtless a part of the debt back. There is no way to pay it back except through an export surplus. And no one has yet to figure out whose going to buy our goods to permit us to get to zero balance, much less a surplus.

I think that Mr. Danielian's observations about a major new address to the trade system is an appropriate one. Most economists who have a sufficiently high ivory tower will say Japan will have to have a trade deficit in the 1990's—not necessarily a current account deficit, but a trade deficit. If that's our best hope, I think we'd better start developing that new trade system rather soon.

Chairman **LaFalce**. Mr. Heckert, you may——

Mr. **Heckert**. May I respond?

I don't think there's any question that both fiscal and monetary policy changes will be required if we're going to get back where we need to be with respect to exchange ratios. I don't think anybody here argues that there was a simple lever that you could pull and deal with the trade problem.

It is necessary—absolutely necessary—to correct these gross imbalances in purchasing power of the currencies, or we simply can't right the problem.

We typically in our industry work with 10- to 15-percent margins. If there is a 60-percent swing in the value of currency, that wipes us out. The game is over. You can't make your plants that much more efficient even if you get rid of all your people and use the best technology in the world.

So that's the dimension of this thing.

Now the other thing that I think bothers our chairman and it certainly bothers us a great deal is the duration of this problem. In capital-intensive industries, we work in 3-, 4-, 5-year cycles. If we get a period of 5 or 6 years when we have the kind of pain we have today and don't make investments, and then things right themselves, it's 3 years before we can respond. It takes that long to build a plant.

And the substance that we're losing in key industries today will not come back in 1 month or 2 months, or 2 years after the problem has begun to be dealt with.

So, from that standpoint, it is extremely urgent that Government understand the need to get on some trend lines that look like we're dealing with our problem so that industry can begin to feel that at least there's a light at the end of the tunnel.

But when you lose substance in these basic industries, in these core industries, over a several year period it has very significant, very long-term implications. I'm talking about half or a full decade.

That's what bothers us as much as anything else.

Chairman **LaFalce**. You know, we've experienced certain problems right now. We don't know the problems we're going to experience in the future because of the corporate decisions that have been made the past few years and will be made the next coming few years to locate plants overseas.

Mr. **Heckert**. Exactly right.

Chairman **LaFalce**. Is there any way—I ask Mr. Fox, or anybody, but especially Mr. Fox—that we have of quantifying the type of corporate decisionmaking that's being made today to give some prognosis of its future impact?

Mr. Fox. Well, we're very much concerned with——

Chairman LAFALCE. Is there any data which would indicate that General Motors decided they're going to do this overseas, Chrysler decided they're going to do this? Du Pont, Kodak, all decided they were going to do this overseas, and it's going to have a devastating impact in the future? Or, minimal impact in the future?

Mr. Fox. What the results might be, we are now undertaking a survey of the major member companies of NAM to ascertain just what you have stated; whether we'll get quantifiable data that can be added up, I'm sort of doubtful about that. I think we could get some telling examples which might be indicative of a trend.

Chairman LAFALCE. What are your expectations for completion of that survey or report?

Mr. Fox. Probably in the next 30 days.

If we rely on the normal Government processes, the Department of Commerce will give us the data 6 years from now. [Laughter.] I'm not kidding. Maybe you would like to write to the Secretary of Commerce and ask for a speedup.

Chairman LAFALCE. OK, from six to five——

Look, everybody who thinks that there is a serious problem says that we have got the macroeconomic problems, and then there are certain microeconomic problems, too. Let's just focus in on the macroeconomic though.

We have always considered macroeconomic problems in terms of fiscal policy and monetary policy. Mr. Danielian is now saying we ought to, when we talk about macroeconomic approaches, talk of fiscal, monetary and exchange policy.

Is that correct, Mr. Danielian?

Mr. DANIELIAN. You have to look at that. That's correct.

Chairman LAFALCE. OK, fine. So you would distinguish that and make that a third important ingredient of macro.

Well, let's go into exchange in a second, but, first, let's deal with the fiscal because whenever you're dealing with monetary you're dealing with the Fed. Whenever you deal with exchange, you're dealing with multilateral solutions in addition to unilateral.

But when you're dealing with fiscal policy, you are dealing with, for the most part, unilateral actions, at least unilateral to the U.S. Government. Therefore, theoretically, we would be able to effectuate those more readily.

Based upon my understanding of the budget, we really haven't increased our level of spending very much in the past 4 or 5 years when we've seen the increase in the value of the dollar. The overall level of spending is approximately 23 plus percent of GNP now. And 4 or 5 years or so ago, it was 23 plus percent of GNP. There's a difference in where that spending goes. We spend a much higher percentage of our spending on debt expense and on defense as opposed to other priorities. Other priorities have been cut in order to maintain that constant figure of 23 plus.

But the gap is because of lack of revenues. About 4 or 5 years ago, our revenues accounted for about 21 percent of GNP. Now it's 18 plus percent of GNP, which has produced the huge deficit.

Is everybody in general agreement with my figures?

Anybody want to controvert them?

[No response.]

Chairman LaFalce. Well, wouldn't it make sense then that we ought to be considering the raising of revenues to the level where they were approximately 4 or 5 years or so ago as a percentage of GNP, if we're going to do something about the fiscal component of our macroeconomic problems?

Mr. Heckert?

Mr. Heckert. I don't have any problem with that.

I think most of the concern of industry is that they're reluctant to take the heat off of Government on the spending side by offering the old concessions on the taxation or income side.

Chairman LaFalce. The time has come to face reality, it seems to me.

Mr. Heckert. But, from my standpoint, you know, we simply must live within our means. That says you've got to exercise control over spending. It also says you've got to face up to whatever your income requirements are.

I think the income question has two dimensions. One obviously is how much. The other, equally important, is how? If you're going to continue to tax savings and income and spare consumption, then our society will continue to be oriented toward consumption and be weak on saving.

So those are the things we've all got to look at. And your statement doesn't offend me a bit.

Chairman LaFalce. Mr. Fox?

Mr. Fox. Well, I agree with Mr. Heckert. I would go on to suggest that we just have to carry it out.

Mr. Heckert referred to the favoring of consumption in our society. The obvious approach to that matter is to raise part of our revenues through a value-added tax, or some similar tax. That would have a beneficial effect on savings. It would have a beneficial effect on our trade, and I suppose ultimately we will get there, but it seems to me it is one of the alternatives that obviously should be under consideration.

Chairman LaFalce. I am really not too interested at this juncture in how because we could debate endlessly on that. I am interested in whether the raising of revenues should be a component of remedying our fiscal problems, which is the unilateral step that we should take to deal with our overvalued dollar.

Mr. Danielian. I think you are going to have to face raising revenues somewhere along the line unless there were massive cuts in defense, and so forth, which I am not sure can be achieved.

If that can't be achieved, you are going to have to look at the revenue side, no question about it.

But I think it is extremely important to look at whether you get revenues from the investment side, or whether you get it from the consumption side. If you don't get it from the consumption side, if you leave that alone, then you open yourself up to more imports because that is where the consumption is going.

Chairman LaFalce. I will get into the exchange policy portion of the macroeconomic approach in a second, but I want to defer my questioning to Representative Carper.

Mr. CARPER. Thank you, Mr. Chairman. I apologize to the panel. I have another simultaneous subcommittee hearing going on in an issue that is important to our State of Delaware. I had to attend at least a portion of that.

The first witness—I am going to ask you to help me with your name. Is it Feketekuty?

Mr. FEKETEKUTY. Right.

Mr. CARPER. I am going to ask you to help me over the next couple of minutes to think through and maybe even to begin to write a prescription for some kind of congressional action to diminish the trade deficit.

As I listened to Mr. Heckert's testimony, I thought I picked up a number of threads that would help us to construct such a congressional package. I would look to you for some similar kind of guidance.

Mr. FEKETEKUTY. Well, I really wouldn't disagree with the basic outlines of what Mr. Heckert proposed.

I think, first of all—I think as I mentioned in my oral statement—we have to address the budget deficit. I think that is the first and foremost issue that must be addressed.

Second, we have to look at the savings issue in the American economy, and that means looking at the tax structure. We have a tax system that favors consumption over savings, and I think we have to change that. Otherwise, our economy is not going to generate the savings necessary for the investments we must make to make the economy competitive.

Mr. CARPER. In your judgment—if I could interrupt—in your judgment, does the Treasury tax proposal do that?

Mr. FEKETEKUTY. No, sir.

Mr. CARPER. Thank you.

Mr. FEKETEKUTY. Not the original one.

Mr. CARPER. Go ahead.

Mr. FEKETEKUTY. In fact, if we look at the numbers, we see that the significant increase in savings that we did generate came from business savings, and that was the result of the last tax reform bill because the depreciation allowances and everything else created a whole new set of incentives for businesses to save, and that did quite well. Where we failed is on the personal savings side, and we have to do something about that.

But I think at the same time we don't want to kill the goose that laid the golden egg.

Chairman LAFALCE. Are you saying that ACRS succeeded, but Kemp-Roth, that is, across-the-board 10 percent, failed?

Mr. FEKETEKUTY. In terms of generating savings, yes.

Chairman LAFALCE. In terms of supply-side economics?

Mr. FEKETEKUTY. Well, supply side—you can argue that it certainly generated demand. It led to tremendous increases in economic growth. But it did not generate savings.

Chairman LAFALCE. Oh, you are saying the supply side generated demand; therefore, supply-side economics is another way of describing demand-side economics? Is that what you are saying?

Mr. FEKETEKUTY. Well, it generated demand.

Chairman LAFALCE. Thank you. [Laughter.]

Mr. FEKETEKUTY. But to get back to the point about savings, I think we want to make sure that in having a tax reform bill that we don't remove many of the incentives that led to business savings, while at the same time increasing the incentives for personal savings.

I think that is absolutely essential.

Third, we have to become more conscious of the impact of a great number of different policies on our trade position. I mean, we have generally run our economy from a completely domestic perspective. Now, that has begun to change. I think we have started to view antitrust policy more from a global perspective than just purely a domestic perspective.

There are a number of other policies where I think we have not given enough attention to the trade implications. Certainly, from our point of view, we want to make sure that the new Export Administration Act is not antitrade, while at the same time, of course, we want to make sure that it accomplishes its overall objectives.

So we do have to become more conscious of the trade effects of a whole series of trade policies.

And then, fourth, I would certainly say that we have to continue to press very hard to get better market access in places like Japan.

Mr. CARPER. It is interesting that you would mention—I think as your third item—the Export Administration Act. Today on the floor of the House we will be considering under suspension the Export Administration Act amendments, and I have before me a summary legislative report that has been prepared by the Democratic Study Group, which does some pretty good research for us, and they noted at the end of their report that the administration's position was unavailable as of press time last Friday, 4 days ago.

I am wondering if you can give me some guidance as to what the administration's position is on this, what I think is a very important bill.

Mr. FEKETEKUTY. I am afraid I can't.

Mr. CARPER. Let me ask a different question then.

You had touched in your comments in your response to my question some need to or some expectation of revising the Treasury tax plan in a way to help us begin to diminish the trade deficit, to do some things that are appropriate.

Could you just elaborate on where you think those changes should take place?

Mr. FEKETEKUTY. Well, I don't think I want to get into specifics, sir, since that is not our area of responsibility.

But in general terms, I would want to make sure that we do look very carefully at exemptions that are related to consumption.

Mr. CARPER. You want to add anything to that?

Mr. FEKETEKUTY. I am not sure I want to go into the specifics, since that is not my role. But I think overall we want to look very carefully at elements of the Tax Code that create a further incentive for personal consumption.

Mr. CARPER. Let me ask one question of Mr. Heckert, if I could.

You touched in your comments about the devastating impact on the textile industry in this country, which we have witnessed for the last decade or so. It seems that there has been a lot of attention paid by us and by the media to the problems within the auto industry and the loss of employment there, to the problems within the steel industry and the loss of employment there. Until recently, we have seen relatively little attention paid to the impact on the textile industry.

In terms of congressional remedies, there is at least one that I am aware of that is proposed. A number of us are cosponsoring.

Would you just care to take this opportunity to—if you wish—comment on that legislation, why it is appropriate for us to take that action?

Mr. **Heckert**. I am sorry, I am not familiar with that in adequate detail. I would like to make a comment if I could, Mr. Carper, in relation to that industry.

I think we all—I hope we all recognize that it is really three levels of production. There is the synthetic fiber manufacturer, and in that regard we are certainly competitive. There is the cloth manufacturer, the weaver, and in that regard I think the American industry is becoming fully competitive where it wasn't formerly. A great deal of investment has been made, and that is not a problem because it is not labor-intensive.

The difficulty comes at the next level, where we make garments, where we fabricate from cloth, and obviously those people who use modern techniques and pay their workers 20 cents an hour do very well against the same technology in the United States and workers paid—well, let's say minimum wage or a little above—$4, $5, or $6 an hour. Now, that is a fundamental problem.

Unfortunately, in following a free, open market ideology to the end, we risk losing the whole chain. It is certainly true that fabricators and garmentmakers overseas will do that job cheaper than it is likely to be done in the United States.

We are working on new technology, and maybe we can significantly overcome that disadvantage in some areas, but, you know, except for taking the labor content out of it, there is no adequate response, and that doesn't help on the employment side.

But the fact is that the emerging countries overseas are subsidizing their fiber industry. They are getting into the business whether it makes any sense or not. They are doing whatever is necessary to get their weaving industry started, subsidizing that where necessary, and exploiting the natural advantage they have in low cost wages.

Now, if we lose that whole chain, we lose a very large, a very significant segment of the economy. We have got really two choices.

We can say, OK, let it go and suffer indefinitely with a very large negative trade balance in that sector, or we can conclude that some percent of our market should be available to outsiders and beyond that it is ours.

Those are not nice decisions.

Mr. **Carper**. Are there any steps in between?

Mr. **Heckert**. Excuse me?

Mr. **Carper**. Are there any steps in between those two?

Mr. **Heckert**. Well, sure, there are. Just dealing with the currency problem is a tremendous assist. Everything we have touched on today that improves the competitiveness of U.S. industry is an assist, but in the final analysis there are some tough calls to be made, and if Government says it is willing not to deal with the problem in a constructive way, then we will lose that industry, or at least a great share of it.

And in the last 4 years, you know, the erosion has been incredible. The percent of the—am I taking too long?

Mr. CARPER. No.

Mr. HECKERT. The percent of foreign manufacture of retail garments up until 3 or 4 years ago was hanging around 22, 23, 24 percent. It is well over 40 now and headed for I don't know where.

But there is a very fundamental issue here that Government has to deal with because the structure of competition is such that the domestic industry cannot protect itself with its own devices. It is that simple.

Mr. CARPER. Thank you.

My time has expired. I just want to again thank the chairman and our witnesses for very valuable testimony. Thank you.

Mr. HECKERT. Thank you, sir.

Chairman LAFALCE. Thank you.

Let's go back to the overvalued dollar as a component of the trade deficits. Two questions. First, to what extent is the overvalued dollar the cause of the trade deficit?

Now, somebody quoted Bill Brock as saying maybe it is 80 percent of the problem. I have heard Bill say 70 percent at different times. You can't quantify it that precisely.

But then I heard somebody else say in testimony—was it you, Mr. Fox, or Mr. Danielian—it was around $50 billion, which if it is $50 billion over $130 billion, it is not quite 70 or 80 percent. It is more like a third, or 40 percent.

Can anybody try to quantify this more or are we just engaging in rough guesses, and one person's guess is almost as good as somebody else's guess?

Mr. FOX. Well, I will volunteer on that. I really do think it is not readily quantifiable. I think you can get estimates that can justify that range from 50 to 80 percent.

I personally think Mr. Brock's figure is on the high side, but we have had two Chairmen of the Council of Economic Advisers——

Chairman LAFALCE. What would your figure be, roughly?

Mr. FOX. About 50.

Chairman LAFALCE. About 50 percent?

Mr. FOX. About 50.

Chairman LAFALCE. Mr. Danielian?

Mr. FOX. But I really think——

Chairman LAFALCE. What would you say?

Mr. DANIELIAN. It is $50 billion, but for me it is half because I am using the balance of payments trade deficit of $108 billion.

Chairman LAFALCE. OK, fine.

Mr. FOX. So we concluded it is half or more.

Chairman LAFALCE. Mr. Heckert, you think about half?

Mr. HECKERT. Half or more. In our industry it is more.

Chairman LAFALCE. OK, right.

Would you quarrel with that seriously, Mr. Feketekuty?

Mr. FEKETEKUTY. No, I wouldn't.

Chairman LAFALCE. No, about half, and half would be to other reasons.

Well, let's focus in on the other half, the overvalued dollar. First of all, what is an overvalued dollar? Because how can we say something is overvalued if the market is telling us what its value is? How can we say it is overvalued when we compare it against 1980, while in 1980 it had experienced about a 40-percent drop from 1978, hadn't it?

Mr. **FEKETEKUTY**. No, I wouldn't look at it in terms of overvaluation, but I would——

Chairman **LAFALCE**. You would or wouldn't?

Mr. **FEKETEKUTY**. Would not. What I would say is what has changed since 1982, let's say.

Chairman **LAFALCE**. Well, how do we describe the problem of the dollar? You can't use the word "overvalued"?

Mr. **FEKETEKUTY**. Well, just say how much has the dollar changed over the 2-year period.

Chairman **LAFALCE**. Well, in order to be descriptive and educational——

Mr. **HECKERT**. May I suggest a way?

Chairman **LAFALCE**. Yes.

Mr. **HECKERT**. I think the problem is that you are exactly right. The market sets the value of the dollar. The problem is that it is not set by the goods exchange market. It is set by the capital exchange market, and that has nothing to do with making cars.

The goods exchange market would rate the dollar very differently than the capital exchange market does, but the capital flows completely overwhelm trade. So that is the problem.

Chairman **LAFALCE**. I didn't mean to interrupt you, Mr. Feketekuty.

Mr. **FEKETEKUTY**. The analysis that I have gone through says that we have had the large increase in the deficit over the last 2 years, from 1982 to 1984. So let's see what has changed during that 2-year period to account for that change in the deficit.

There, you can just look at the change in the dollar and say, all right, given that change in the dollar, how much of it could have affected the change in the deficit? And you use the normal tools of economic analysis, such as elasticity calculations, and so forth. Within a normal range of elasticities and a timelag that most economists would be willing to accept over about a half a year for accounting for about half the change, you can explain about half of the deterioration of the deficit.

So, you know, given a number of assumptions, you can come up with certain explanations.

I, myself, have also looked at the shift in our balance vis-a-vis the developing countries. Now, that accounts for $27 billion over the last 2 years. I would assume that most of that $27 billion is accounted for by the debt problems of these countries. So there again we have another explanation.

Then if you look at the differences in growth rates between the United States and Europe, and you assume that there is a certain relationship between growth and imports——

Chairman **LAFALCE**. Well, you're going back to your original testimony now and just rehashing the causes, but that wasn't my question. Is the dollar really overvalued, and what is your determination of overvalued? How you can say what the appropriate level ought to be of the yen vis-a-vis the currency, and anything above that is overvalued and anything below that is undervalued.

Mr. Fox. I am surprised with the question being raised so many times and it being dealt with as if it were a theological subject. It is obvious that the traditional way of looking at the value of a currency is in relation to goods and the sale of goods relative to the prices of those goods.

There is a theory——

Chairman LaFalce. But Mr. Heckert has said that we are not doing that though.

Mr. Fox. No, Mr. Heckert referred to a purchasing power parity concept, which is the normal traditional way of judging a value of currency and its relationship to another currency on the basis of sort of a basket of what it would buy, in terms of typical goods.

Until we got into this current floating exchange rate system, which I assure you was not by plan, but because they couldn't figure out anything else to do after 1973, we assumed that purchasing power parity concepts were determinative of the value of the currency and that capital movements were supplementary. Well, it is obvious that we have exactly the opposite position today in 1985 from 1973——

Chairman LaFalce. Do you gentlemen deal with this precise issue in your testimony at all?

Mr. Heckert. I did not in this——

Chairman LaFalce. No. You did not. Did you, Mr. Fox, Mr. Danielian?

Mr. Danielian. I did only to the extent of the recommendation that I made.

Chairman LaFalce. Would you supplement this definition of the problem——

Mr. Danielian. Yes. I'll be glad to do that.

Mr. Fox. What we simply said in my testimony was, using a Federal Reserve Board index and citing the Council of Economic Advisers, that the dollar is 65 percent higher now than it was in 1980. But you are asking for a more conceptual statement as to what is overvaluation in the context of traded goods or some other basis that is recognized among economists and others, and we will attempt to supply something for the record.

Chairman LaFalce. But only because I have heard administration officials say we don't have an overvalued dollar.

Mr. Fox. That's known as denial.

Chairman LaFalce. Yes. Yes.

Mr. Danielian. They are denying the problem.

Chairman LaFalce. That's right, I have heard administration officials say, we don't have an overvalued dollar, because the value of the dollar is what the market gives it. So the market is giving it, it is not overvalued. Now we might have some other problems, but it's not an overvalued dollar. And that is why I am trying to focus in on that issue.

[In response to Chairman LaFalce, the following letter was received from Mr. Danielian containing the information requested above:]

International Economic Policy Association

1400 EYE STREET NORTHWEST WASHINGTON D C 20005

FOUNDED 1957

(202) [illegible] 2020

April 26, 1985

The Honorable John J. LaFalce
Chairman
Subcommittee on Economic Stabilization
Committee on Banking, Finance and Urban Affairs
U. S. House of Representatives
Washington, D. C. 20515

Dear Chairman LaFalce:

During hearings before the Subcommittee on April 16, you asked that I supplement the definition of the problem and clarify the purchasing power parity differences facing the United States since floating exchange rates in 1973.

At the end of the 1960s, there were recurring crises in the value of major currencies as the financial flows became too great for the Bretton Woods fixed exchange rate system to hold together. Since the convertibility of currencies into gold for settlement purposes was through the U.S. dollar at par values accepted by the IMF, fixed exchange rates placed the burden on the United States for stabilizing the system. The dollar retained a set value in relation to one ounce of gold and changes in other currency values which occurred were paid for by us--most often through an overvalued dollar as other currencies were depreciated.

After 1971, our payments imbalance was too large and the dollar depreciated. A temporary Smithsonian Agreement was negotiated to try to maintain currency values in some agreed ranges. Unfortunately, pressures continued to mount and governments were unable to maintain currency values as pledged. By 1973, after the dollar had depreciated by approximately 15 percent, the system collapsed and ushered in the era of floating exchange rates.

The theory behind floating exchange rates was that currency changes would reflect the relative purchasing power parities between nations in the tradable goods sector. It was felt that large current account and/or trade deficits would be self-corrective as the currency of the country whose accounts were in imbalance would depreciate, thus giving that country added export opportunities. The correction would continue until the trade and/or current account showed some substantial improvement at which time the currencies of major trading nations would readjust to a new equilibrium level. You should note that in 1971 IEPA stated on the record that floating exchange rates would not solve our payments problems.

Unfortunately, financial flows have grown to such magnitudes that asset shifts among nations have been the determinant of currency values rather than the relative differences in the real costs of production. Thus, the tradable goods sector has suffered in those countries with an overvalued currency and import penetration has caused dislocations in the domestic market.

The belief that flexible exchange rates or revaluation of other currencies will turn the trick on our commercial transactions is a hangover from classical international trade theory. Unfortunately, this is not applicable to a world where the classical model of competition, free trade, and mobility of capital and labor simply does not apply. Over the past decade and a half, the dollar has moved up and down. First, it depreciated, then appreciated (in the mid-1970s). Starting in 1977, it depreciated again substantially-- by 30 percent, and has now appreciated to the point where it is significantly overvalued. At no time during this period did the United States trade or current account adjust as theory says it should have in money terms. In fact, the adjustment in money terms when the dollar depreciated by 30 percent was only about $4 - 5 billion, which represented less than 20 percent of our current account and less than 17 percent of our trade account deficits. In addition, as Federal Reserve Bank studies have shown, the United States seems to lose more when the dollar appreciates than we gain when it depreciates by the same amount.

In determining whether a currency is under or overvalued for goods, an index of the real, effective exchange rate can be used to determine the purchasing power parity in the tradable goods sector. This index is built upon effective exchange rates, a measure of a currency's trade-weighted average appreciation or depreciation vis-a-vis other currencies, and then is adjusted for inflation differentials. A good index is the one used by Morgan Guaranty Trust Company in their World Financial Markets of July 1983, which was based on March 1973 values. They use wholesale prices of nonfood manufactures in their adjustment to reveal the real cost changes in the traded goods sector. The result shows the amount by which currency swings are out of step with the costs of production in various economies. Using March 1973 as the base, by June 1983 the dollar was overvalued by 18.7 percent and the yen undervalued by 12.2 percent so that the total difference was 30.9 percent in goods traded between us.

The idea behind exchange-adjusted tariffs is that a correction would be made in the tariffs of the appreciating currency country so that trade competition in the home market would be based upon real cost differences. Without such an adjustment, we face a continuing import penetration (not based upon real cost advantages), the closing of industries which normally would be competitive, and the forcing of production overseas. U.S. manufacturers are responding to their environment and trying to adjust so they can continue in business. As long as there is the possibility of continuing overvaluations now and in the future, there will be undesirable side effects to our blind adherence to a failed theory.

One important benchmark that should be used in exchange-adjusted tariffs is the base year of 1973 for calculating purchasing power parity values. To use a later period would penalize the United States for any differences that occurred in the meantime. Also, by 1973 the dollar had made a modest adjustment from the fixed exchange rate regime. This put it more in line with actual parity since most observers believe the dollar was overvalued in the 1960s.

You also asked me to detail my idea of exchange-adjusted tariffs for legislative consideration. I shall do so in a separate letter.

If you or the Committee have any further questions, please contact me.

Sincerely,

Ronald L. Danielian

Ronald L. Danielian
President

Mr. DANIELIAN. And whether a currency is over or undervalued, is looking at whether it is partly sunny or partly cloudy. That is another problem.

Mr. FEKETEKUTY. But the other thing, you don't want to assume that there is any given level of capital flows that is natural. I would assume in a situation where the American economy was booming——

Chairman LAFALCE. And you are, therefore, saying that capital flows should be a valid criteria in determining the exchange rate?

Mr. FEKETEKUTY. That's right. There are situations where you are going to get shifts in investment patterns, and it is quite natural to get shifts in capital flows during those periods. The question is whether some of those capital flows could have been avoided, had we had a lower budget deficit, had we had higher savings, and the answer is yes.

Chairman LAFALCE. Mr. Fox and Mr. Danielian, do you want to take——

Mr. DANIELIAN. And also, whether the effects of what has happened is good or bad for the economy. You've got to look at that.

Mr. FOX. My friend Geza, has raised the question, I think can be illuminated by perspective.

Chairman LAFALCE. Can I also make you my friend, Geza, as I have problems? [Laughter.]

OK. Good. I should have done that earlier.

Mr. FEKETEKUTY. I am not sure I like the tone of your last—— [Laughter.]

Chairman LAFALCE. No, no, no, no, no.

Mr. FOX. Under the Bretton Woods system, accounts were settled between countries by movement of capital, by and large, whether or not a country had a current account trade surplus or trade deficit, to determine how much capital it had to transfer to the country with whom it had the deficit. That was calculated on what was called an official settlements basis. You could figure out how much had to be transferred from Great Britain to Germany to settle the account.

Under the present system, we have no anchor. We don't have the official settlements basis. We don't have to transfer funds on the official basis to cover the account. Capital movements take place. They appear to take place in the direction of the United States spontaneously. I must say, the explanation that is most popular with the Treasury today is that we have such a super economy everybody wants to put money into it.

It happens that the dollar began to rise and rose during a period of a serious recession. The weight of the different factors——

Chairman LAFALCE. That is a very interesting point that I missed, yes.

Mr. FOX [continuing]. That influence the capital flows vary, but generally speaking, one thing that has been very important is the real interest rates paid in the United States. It seems to me, in terms of objective, we want an exchange rate system that facilitates trade flows, doesn't determine the trade flows, and that's what we have now. The exchange rate really determines whose goods are cheaper rather than how much it costs to produce your goods.

Chairman LAFALCE. All right. Now you gentlemen, particularly Mr. Fox, Mr. Danielian, have come up with some specific prescriptives for the exchange rate problems that we have.

Let me just take two of the NAM's on pages 2 and 3 of exhibit 6.

> Take steps to decrease worldwide use of the dollar as a convenience transaction currency, not by restrictive measures but by positive encouragement to use the yen, mark, and other currencies more extensively in commercial transactions and central bank reserves.

Next,

> Explore in consultation with other countries, the possible advantages of issuing U.S. Federal debt issues in currencies other than dollars.

Let's take that first one. You know, I am not an expert on the dollar or international foreign exchange, but aren't there some economists who think that having the dollar used as a worldwide currency is a very good thing? And, if you are arguing that we should decrease use of the dollar as a worldwide currency, that ultimately this is going to be harmful to U.S. exports and harmful to the U.S. economy?

Mr. Fox. I see no reason why it should be harmful to our exports nor to our economy. Obviously, an industry which moves money around prefers to operate in its own currency. What I am saying is, reducing the role of the dollar as a convenience transaction currency may not be as popular a suggestion among some banks as it would be among some manufacturers who are seeking a more realistic exchange rate.

Chairman LAFALCE. Geza, do you have any thoughts on that?

Mr. FEKETEKUTY. Well, I would prefer other means of trying to change the balance and demand supply of dollars. I do think that the New York capital market is a very important asset that we have. It helps our businesses raise funds. To take actions that would reduce the competitiveness of the New York finance market may not be in the long-term interest. So while I understand the reasons for the recommendation, I am not sure that I would support it.

Mr. Fox. The purpose is to increase the demand for other currencies and, therefore, raise their value. This job doesn't have to be accomplished just by reducing the value of the dollar. And there is a lot to be said for a system that has other strong currencies used as reserve currencies and as transaction currencies, and I don't think there is any necessary loss in efficiency in that. If Japan has a greater interest in a stable exchange rate system because it has reserves in that system all over the world, I think Japan would play a greater role in trying to see a better exchange rate system. Japan has every reason, under present conditions, to sit back and let the dollar play that role.

Chairman LAFALCE. The difficulty I have is that the U.S. economy was a more dominant economy worldwide over the 1960's and 1970's, and we didn't experience this overvalued dollar. The utilization of the dollar as a means of foreign exchange was greater, I think, in those two decades than it has been the last 4 or 5 years.

Mr. Fox. Mr. Chairman, I don't think your facts are correct.

Chairman LAFALCE. That may be.

Mr. Fox. Most of us were in the——

Chairman LAFALCE. Although Geza and Mr. Heckert were nodding their heads in agreement.

Mr. Fox [continuing]. The dollar began to become overvalued in the late 1960's and that continued through the devaluation in 1971, when the gold window was closed, and we took the first devaluation. Probably in 1973, it might have been about right. If you look at it in the longer perspective, the Bretton Woods system worked fairly well, except it did permit a number of major currencies to be undervalued. The Japanese yen was undervalued in most of the period of the Bretton Woods system, which added to their advantage in penetrating world markets, making their goods cheaper and making foreign products expensive in their home markets, and that is a fact of life that one should not ignore. It was certainly understood in the Ministry of Finance in Japan and pursued as a policy. It was one of the reasons why the Bretton Woods system lasted as long as it did, because it was so convenient for so many countries, toward the end, to trade against an overvalued dollar.

Mr. DANIELIAN. It was also a U.S. policy after World War II, to send U.S. dollars abroad building up liabilities so that other people had purchasing power. There was a world liquidity problem at the time. In addition, other currencies settled through the dollar, because it was the dollar that was exchangeable into gold. So when you made a settlement or transaction, again, it was through the dollar into gold.

So all those things combined led to a system where we, in essence, gave more purchasing power to other people, through an overvalued currency, based upon fixed exchange rates.

Chairman LAFALCE. One specific prescription of yours, Mr. Danielian, for exchange rate policy that Mr. Fox has called for as an opponent of macroeconomics, would be to consider the use of an exchange adjusted tariff, to adjust the trade effect on misaligned currencies. That has a certain appeal to me. If we couldn't solve the exchange rate problem, compensate for it.

I would first want to attack the exchange rate problem and try to bring that into some appropriate equilibrium to query how we could best do that. We'll get to that in a second.

First, let me focus in on the misaligned currencies in using the exchange adjusted tariff as a means. How would you suggest structuring that, and what would the opinion of you gentlemen be about that?

Mr. DANIELIAN. The idea behind it is to look at the situation as some of the gentlemen here have stated, and say that these capital flows are causing an aberration on the exchange rates, and therefore, changing the tradeable goods sector significantly. Creating an area where we once had a comparative advantage into an area where we no longer have one; where we are least advantaged.

If you look at it in those terms, you say to yourself, well, all right, take the period 1973 when the world went on floating exchange rates. Between 1971 and 1973, the dollar depreciated about 15 percent. If you say the dollar was overvalued in 1971, pick the year 1973 when it was down about 15 percent. Then you look at purchasing power parity between nations. From that point on, you would judge the tradeable goods sector on this parity. You would say, well, all right, from 1973 to at least 1983, the U.S. dollar is around 30 percent overvalued, based upon what it should be in terms of inflation between countries in the interim.

Morgan Guaranty had an index based first in 1973. If you look at it, adjusting for inflation in various countries, purchasing power parity shows the dollar is overvalued. Other currencies can be undervalued. The yen under that index was undervalued by about 10 percent.

And what you would do is, you would say——

Chairman LaFalce. Is there fair international consensus regarding the validity of that index?

Mr. Danielian. Well, there is a fair consensus about the validity of the concept. The problem is, people would argue, which time period to use to base it on. You can always have an argument on that. You can pick a shorter time period and say, wait, it's not 30 percent overvalued. It's only 10 percent overvalued. So there is a——

Chairman LaFalce. Actually, you would have to come to grips with that problem, if you are attempting to do something about the misalignment of the currencies, too, not just the exchange tariff.

Mr. Danielian. Yes, you would, but you can look at the fundamental equilibrium that you want to achieve in our current account, and you can say to yourself, that to achieve a certain amount on this account, the dollar is going to have to change by *x* amount.

Chairman LaFalce. To your knowledge, is the administration engaged in dialog with other countries to even come to grips with the nature of the problem of misalignment, or are they just——

Mr. Danielian. They wanted to separate the issues, simply because they don't want the international monetary issue to overshadow some of the GATT negotiations, and only just recently has the Treasury Department been willing to finally open up and say, "Well, OK, while we have some GATT meetings, we will have a special conference or look at some of these monetary issues."

Chairman LaFalce. This is more important than GATT, or it ought be a principal component of GATT.

Mr. Danielian. I think it is more important.

Chairman LaFalce. I interrupted your train of thought.

Mr. Danielian. No, I am just saying that is a stumbling point, in terms of looking at what time period you take, but I think generally, if you look at what it would take to bring some sort of equilibrium back into either the current account or some sort of adjustment in the trade account, you can figure out whether the dollar is 40 percent overvalued or 15 percent overvalued. I mean, the overvaluation of the dollar and undervaluation of other currencies is so great today, that within a reasonable error of maybe 5 percent, you could certainly tell if one is in one position and another is in another position.

The idea would be to take that and say, all right, we are going to sit down with the trading community and say, "Look, we've got a problem, and we are going to have to apply some sort of adjustment to this, like an exchange adjustment——

Chairman LaFalce. Now let me just stop you there, because in order to get to some exchange rate based tariff, you would have to have a multilateral consensus as to the problem.

Mr. DANIELIAN. Why? Why multilateral? If I was Japan and getting a trade advantage, I would not come to a consensus on the problem.

Chairman LAFALCE. OK.

Mr. DANIELIAN. So you offer the opportunity to discuss it in a multilateral form, but I think we should turn toward our own resources to look and discuss the issue, analyze it and see whether it's feasible.

Chairman LAFALCE. Suppose you could come to this multilateral consensus then, which, as you point out, is not necessary to take an exchange rate base tariff approach, but suppose you wanted to take some multilateral action to deal with the misalignment. What would the multilateral actions be that would be able to bring the misalignment into equilibrium, assuming that there is a multilateral consensus regarding the misalignment?

Mr. DANIELIAN. In other words, what actions other than the exchange of tariffs——

Chairman LAFALCE. Yes.

Mr. DANIELIAN [continuing]. Such as some actions that Mr. Fox mentioned in his testimony? I think you do have to get together and discuss with countries on trying to have an intervention system that cuts the peaks and the valleys. However, I don't think intervention can set a rate.

Chairman LAFALCE. Is this similar to what Fred Bergsten is talking about, his target zones or——

Mr. DANIELIAN. No. No, because I think that there is an implication in that, that you can just about get down to the rate you want and I don't think that's possible.

But second, I think that you've got to sit down with countries and discuss whether or not the alternative of having an exchange adjusted tariff on their exports to us is acceptable. Monetary policy has got to change in foreign countries and this might force the issue.

Chairman LAFALCE. I would like you to flesh your ideas out in writing to me for legislative consideration.

Mr. DANIELIAN. All right.

[In response to Chairman LaFalce, the following letter was received from Mr. Danielian containing the information requested:]

International Economic Policy Association

1400 EYE STREET, NORTHWEST, WASHINGTON, D.C. 20005

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April 26, 1985

The Honorable John J. LaFalce
Chairman
Subcommittee on Economic Stabilization
Committee on Banking, Finance and Urban Affairs
U.S. House of Representatives
Washington, D. C. 20515

Dear Chairman LaFalce:

During hearings before your Subcommittee on April 16, I proposed further consideration and study of the use of exchange-adjusted tariffs to counteract the trade effect of misaligned currencies. This would return us to a system of open markets that compete on the basis of comparative advantage in real costs. You asked me to clarify my ideas to you in writing "for legislative consideration."

Trade in financial assets, the flow of banking and investment funds across borders today, is setting the value of currency relationships. Real costs of production, quality differences, and the system of trade under comparative advantage is being adversely affected because this sector is much less important in determining the value of the dollar. Thus, the value of the medium of exchange used in the goods sector is being set outside of this area and adversely affecting the price of traded goods. In order to adjust for this, a country whose currency appreciates significantly above purchasing power parity trends might use exchange-adjusted tariffs within a well-defined set of criteria. One such set is attached as Annex I.

Direct investment is a key component in our trade accounts, because at least one-third of U.S. exports go to American companies abroad. The same "trade follows the flag" association would be true also for other countries. Thus, it would be somewhat more appropriate to use the current account deficit as one of the determinants in applying an exchange-adjusted tariff. Suggestions were made to me by members of the Senate Finance Committee that maybe the trade balance should be used as a determinant. This could also be explored, but in my example I use the current account. Then there should be a trigger for the size of the deficit along with a de minimis parity change within which no adjustment would be made. All of the above must be framed with appropriate definitions.

First, it is necessary to start with a precise definition of the current account. The U.S. current account should measure the current flow of exchange across the U.S. border to pay for goods and services. Unfortunately, starting about 1977, the present government accounts included reinvested earnings of foreign investment here and American investment abroad. Thus, a very large positive amount was included for reinvested earnings of American corporations abroad. This inflates and overestimates our current account earnings. Below the current account in the capital account items of our balance of payments, the exact same figure is netted out. The overall effect, therefore, is a zero-zero balance, but the present effect on the current account alone is a fictitious positive inflow.

Secondly, net direct defense expenditures, which are a separate line item in the present U.S. current account, should be deducted. Our NATO expenditures in Europe, for instance, are so large that with Germany we registered an additional outflow of dollars amounting to almost $4 billion in 1983. Our current account is made that much worse with this country but I really believe that defense expenditure issues should be considered separately. The Congress may wish to reduce or offset these expenditures, but that is an issue that must be argued on its own security merits. I would not penalize a country by including this amount.

Finally, the trade effect of the special U.S.-Canadian auto agreement should be eliminated. This is a special agreement allowing zero tariffs in U.S.-Canadian auto trade and was ratified separately by the Congress. Its possible inclusion in any current account for basing exchange-adjusted tariffs should only be by amendment to that agreement. It was the idea of the Congress that a free trade area in autos would be desirable at the time the agreement was ratified and it would be ironic to negate that by an exchange-adjusted tariff.

Next, the misalignment of currencies should be determined by using the real effective exchange rates. I propose that the index used be based on March 1973 as equalling 100, which is the same index that was used up through the summer of 1983 by the Morgan Guaranty Trust Company in their publication World Financial Markets. It is important that the benchmark that should be used in exchange-adjusted tariffs (for calculating purchasing power parity values) is the base year of 1973. To use a later period would penalize the United States for any differences that occurred in the meantime. Also, by 1973 the dollar had made a modest adjustment from the fixed exchange rate regime. This put it more in line with actual parity since most observers believe the dollar was overvalued in the 1960s.

In addition, because there could be errors, the total percentage of misalignment (being the full index point differential between the U.S. and the target country) could be adjusted by subtracting a five-point leeway. This would ease the operation so that small changes in purchasing power parity would not have to trigger an exchange-adjusted tariff and differences of opinion in calculating trade figures or purchasing power parity figures would be covered by this de minimis amount.

Then, if there is a persistent current account deficit extending over four quarters during one year and the current account deficit with one country represents a certain percentage (in my case I use a 20 percent threshold) of the U.S. total current account deficit for the year, the percent of misalignment of both currencies would be determined. This percent of misalignment with a 5 percent de minimis subtracted from the figure, would be applied as an added tariff for a one-year period. At the end of one year, a review would take place starting with the test for persistence and percent of the total current account deficit. If both criteria are still applicable, then the new misalignment would be determined and a new tariff would be applied for the next year.

The use of a one-year period for the tariff would bring more certainty for the traded goods sector. Constant changes would not occur except for a "fail safe" outlined under roman numeral II (A)(4)(a)-(c). This would be in the unlikely event that an aberration caused the "persistent" current account deficit. Also, the use of a threshold percentage for a current account deficit with one country would obviate the need to apply this to over 140 countries. Only where we have serious problems might this system apply.

I believe it would not be difficult to outline legislation using the criteria under II in the annex. Such authority could be an amendment to Section 301 of the Trade Act of 1974 as amended by the Trade Agreements Act of 1979 and the Trade and Tariff Act of 1984. To my thinking, such legislation would not be discretionary, i.e., dependent upon a finding by the President or the U.S. Trade Representative that countries engage in acts or policies or practices which are barriers or distortions of trade. Once the criteria are met then a tariff would be applied.

Such a measure would be used for the purpose of improving the economic stabilization and competition within the American economy. Its thrust is to ensure a more orderly domestic economic environment in which open and free competition can take place for internationally traded goods.

Your Committee may wish to ask for further independent objective study of this idea from a body such as the International Trade Commission.

I would be glad to work with your staff at any time to discuss other alternatives on these important international issues facing the United States. Thank you for the opportunity to testify at your hearings.

Sincerely,

Ronald L. Danielian

Ronald L. Danielian
President

Enclosure

ANNEX I

Definitions and Possible Criteria For the Use of Exchange-Adjusted Tariffs

I. Definition

A. The current account must be defined as those current U.S. transactions on trade in goods and services EXCLUDING:

1. Reinvested earnings--these are not inflows but are added to the government's current account figures and subtracted from the capital account. The overall effect is a zero-zero balance but the present effect on the current account is a fictitious positive inflow.

2. Net direct defense expenditures--these are a separate line item in the present current account. However, our NATO expenditures are so large in Germany, for instance, $3.7 billion in 1983, that this issue should be considered separately.

3. The trade effect of the special U.S.-Canadian auto agreement should be eliminated. As a separate agreement ratified by the Congress, its possible inclusion should only be by amendment to that agreement.

B. Misalignment of currencies shall be determined by using the real effective exchange rates--the index of the effective exchange rate adjusted for inflation differentials, measured by wholesale prices of nonfood manufactures. The effective exchange rate is the measure of a currency's trade-weighted average appreciation or depreciation vis-a-vis the currencies of 15 other major countries. An index would be used based upon March 1973 = 100. This is the same index used up to the summer of 1983 by Morgan Guaranty Trust Company in World Financial Markets.

C. The percentage of misalignment would be the full index point differential between the U.S. and the target country. To account for any possible errors, a 5 point leeway could be subtracted from this difference.

II. Criteria

A. The following steps in order of listing would determine exchange-adjusted tariffs and their use. Such use would be on a country basis.

1. There must be a persistent current account deficit with the target country. "Persistent" would be classified as occurring over four consecutive quarters during one calendar year.

2. The current account deficit with the target country represents 20 percent of the U.S. total current account deficit for the year.

3. The percent of misalignment of both currencies would be determined.

4. When both 1 and then 2 are met, then 3 would be applied as an added tariff for a one-year period. Except that as a failsafe if:

   a. The U.S. subsequently experiences a current account surplus with the target country for one of the first two quarters after imposition of the extra tariff, AND

   b. The average exchange rate relationship readjusts to within 5 percent of parity, THEN

   c. The tariff would be dropped after the two quarters.

5. At the end of the year, a review would take place, starting with step II.A.1, then 2, and, if necessary, then 3 and 4.

Chairman LaFalce. Mr. Fox?

Mr. Fox. I'd like to comment on the exchange rate adjusted tariff and I think it would be sufficiently a threat to other countries that they would come to agreement fairly quickly on other means to improve the exchange rate system. The block to improving the exchange rate system so far has been the unwillingness of the United States to discuss alternatives. It may be that Secretary Baker last Saturday came to the conclusion that he would be prepared to do that. We'll see.

Unfortunately, Baker did say at the end of his statement, he didn't think too much had to be changed. I don't think that making a rickety system better—you'll excuse this, Ron—by sort of a Rube Goldberg variable tariff that varies for each country and it may vary from day-to-day or week-to-week, is the way to go. I think there must be a better approach than that.

Chairman LaFalce. Sometimes you have to come up with those approaches, though, as suggestions in order to get others to listen or agree to the better approaches. Would you agree with that?

Mr. Fox. Yes, I'd make a generalization. Either we learn how to manage money internationally or we're going to end up managing trade. What form of management that trade will take, of course, one doesn't know. I think the exchange rate adjusted tariff is sort of a clumsy way to go about it; I would go more directly to improving the exchange rate regime.

Chairman LaFalce. The direct way is to start out with the exchange rate adjusted tariff.

Mr. Fox. Ron's got a lot of different ideas, and I think there's enough merit in some of them to be given consideration.

Chairman LaFalce. The problem is, it seems to me, that none of these ideas have been kicked about or talked about within the administration in the past 4 years.

Mr. Fox. His reference to conditional MFN is quite a serious one. If we had applied a conditional MFN to countries that insisted on persistently undervaluing their currency, we might have achieved some favorable results. If we had started that about 1962, our situation with Japan would be quite different from what it is now. We would still have a trade deficit in my opinion, but I think it would have made a tremendous difference.

So I don't want to indicate all new ideas are beset with the difficulties that I see associated with the exchange rate adjustment of tariffs, but I think new ideas are needed.

Chairman LaFalce. Let me just give Geza a chance to comment here if he wants to.

Mr. Feketekuty. Well, Mr. Chairman, I'm afraid that all of this is dealing with symptoms rather than underlying causes. The underlying issue is are we going to try to have a monitoring budget policy that is in equilibrium with those of other countries or aren't we? If we do, then all of this is unnecessary.

I think the European Community, which has been trying to peg rates to each other within the narrow range, has certainly discovered that where their fiscal policies ran out of alignment with each other, there was no way of saving the snake. And all these gimmicks, I think, will probably do more damage to our free enterprise, free market approach to things and that——

Chairman **LaFalce**. Is that what we have now?

Mr. Heckert, didn't you say that's what we don't have?

Mr. **Heckert**. Well, we have a one-sided arrangement like that at this point.

Mr. **Danielian**. Mr. Chairman, I think that's correct only if you believe—and really believe—after looking at the history of the last 10 or 14 years, that Socialist France, business-oriented Germany, conservative Reagan, Margaret Thatcher, and Nakasone are going to sit around a table and adjust fiscal and monetary policies in their own countries to swap employment and unemployment. One year I get employment and you'll have to take unemployment, and the next year it will be reversed.

I think that's a little too simplistic to think that in 2 years, 3 years, or 5 years, we're going to be able to get to a system where countries are going to start trading on those terms and setting fiscal and monetary policy.

Mr. **Feketekuty**. I don't think that's what's involved, Ron. I don't think you're swapping employment. I think it's a question of how do you get to employment.

Mr. **Danielian**. It is a question of how, and in the last 14 years, when we've come to the bargaining table, we blink first. So, when that happens, you say to yourself, how achievable is this in the future?

The latest Japanese proposal is for whistling teakettles and Teflon pans. They want the Japanese to buy—among the list of items—whistling teakettles and Teflon pans. I don't know, maybe I should go and look in the statistics and see how many teakettles and Teflon pan manufacturers there are in the United States to see how much we can sell the Japanese.

Mr. **Heckert**. I'll go for the Teflon. [Laughter.]

Chairman **LaFalce**. Well, we started discussing the problems, in my judgment, caused in large part by the Teflon presidency, and we have ended with Teflon.

Thank you.

[Whereupon, at 1 p.m., the hearing was adjourned, subject to the call of the Chair.]

U.S. TRADE POLICY

TUESDAY, APRIL 30, 1985

HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON ECONOMIC STABILIZATION,
COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS,
Washington, DC.

The subcommittee met at 10:30 a.m., in room 2128, Rayburn House Office Building, Hon. John J. LaFalce (chairman of the subcommittee) presiding.

Present: Chairman LaFalce; Representatives Kaptur, Levin, Torres, Kanjorski, Shumway, McKinney, Bereuter, McCandless, and McMillan.

Chairman LAFALCE. The Subcommittee on Economic Stabilization will come to order.

Last year our trade deficit with Japan rose to $37 billion, more than 30 percent of the $123 billion total. That figure represents a 51-percent increase over the 1983 bilateral deficit of $19 billion, and the gap is expected to widen yet again this year.

These are not just numbers. This serious trade imbalance threatens our economic recovery, our industries, and hundreds of thousands of American jobs.

Japan has been charged with doing a masterful job of throwing up roadblocks to limit the purchase of foreign goods. The Japanese, in turn, charge that U.S. companies have made little effort to design and market quality products that meet Japanese consumers' demands.

To the degree that our dramatic deficit reflects only an inability of the United States to produce products and services competitive in the Japanese market, we have no one to blame but ourselves. In such cases, it is our responsibility to improve the competitive position of our industries, not to insulate them behind trade barriers of our own.

But Japanese barriers to competitive U.S. goods and services are real. The Department of Commerce has estimated that our bilateral trade deficit could be reduced by perhaps $12 billion if U.S. goods and services had open access to Japanese markets.

Over the past 4½ years, Tokyo has proffered at least a half dozen market-opening packages that the Japanese have touted as major trade concessions. Each has been accompanied by assurances that imports would rise. Yet, nothing or very little changes. These concessions have produced little in terms of actual increases in U.S. sales in Japan.

Recent events demonstrate the problem all too well. The administration abandoned the voluntary restraint agreement on autos with Japan in hopes of greater access to Japan's markets for U.S. goods and services in key sectors. The Japanese have responded with a 25-percent increase in automobile shipments, most of which I point out will go to General Motors and Chrysler to be marketed under their nameplates in the United States.

Meanwhile, there has been little except promises in the course of recent negotiations regarding substantially increased American access to Japanese markets.

The administration has focused its efforts on telecommunications, hoping the recent privatization of Japanese industry would create substantial opportunities for U.S. firms. The telecommunications negotiations have been tortuous. Concessions have been made, but it's still unclear what these concessions will produce in the final analysis.

Following the breakup of American Telephone & Telegraph Co., Japan increased its exports from $600 million to $2 billion. American sales in Japan remain at about $300 million. No one is daring to suggest that we will see any dramatic increases.

While we have focused our attention on the details of Japanese auto imports and telecommunications policy, it is the Japanese system across the board affecting an entire range of industries and services that is the problem. Japan's barriers to other U.S. exports such as pharmaceuticals, medical equipment, wood products, agricultural products, and other goods and services have become intolerable.

Talks in many of these areas are just beginning. Little progress is evident. All the while we talk, the trade deficit climbs.

No open world trading system can exist if a major trading nation bases its economy on exporting goods to the world while adamantly refusing to import anything other than necessities.

From the Japanese point of view, such an approach may appear useful as it provides an economic incubator in which their growth industries can develop. But this tactic will finally do severe damage to the world trading system on which all nations rely.

The pressure on nations like our own increasingly asked to serve chiefly as the repository of Japanese goods and services is unsustainable. Let me reiterate again that the United States is far from blameless in regard to its deteriorating trade balance with Japan. Many of our problems are "made in America." We need to confront our budget deficits which require us to import capital from the rest of the world which helps to keep interest rates high and the dollar uncompetitive.

We also need to produce better quality goods and services which can beat the international competition.

But, having acknowledged our shortcomings, the bottom line is that Japanese trade practices are totally unacceptable in a world system which is supposed to foster the free exchange of goods and services among countries.

From an international perspective, the United States must demand changes in Japanese policy before the world trading system reaches a breaking point. From a domestic perspective, this Nation can no longer sit idly by while Japan's trade practices build and expand Japanese industry at the expense of American firms and workers.

We are pleased to have with us today the following witnesses to explore these important issues: Hon. Lionel Olmer, Under Secretary of Commerce for International Trade; Jack McDonnell, group vice president of the Electronic Industries Association; Ronald Myrick, vice president of Mostek/United Technologies Corp., testifying on behalf of the Semiconductor Industries Association; Harry Freeman, executive vice president, American Express; and Prof. Kent Calder, Princeton University.

Before we call our first witness, I would like to recognize the distinguished ranking minority member of the subcommittee, Representative Norman Shumway.

Mr. SHUMWAY. Thank you, Mr. Chairman. I would like to join with you in welcoming this distinguished panel of witnesses before the subcommittee today.

I might just say at the outset that this subject is one that perhaps would better put us on the other side of the table so that we could be there testifying as other witnesses are today before this subcommittee because obviously you and I and perhaps other Members have some very significant feelings on this subject.

The statistics are in as to the size of the U.S. trade deficit for 1984. It's $123 billion, with more than one-third of that figure accounted for by Japan. Indeed, our country has never experienced a trade deficit of this magnitude. Our largest merchandise deficit before 1982 represented only 1.6 percent of GNP compared with 3.6 percent last year. Obviously, this represents a significant drag on the U.S. economy and erodes our industrial base that is so critical to our economic growth and national security.

Equally important are the economic hardships that our trade deficit works on American workers as foreign goods are generally cheaper than those with "Made in U.S.A." labels.

While I agree that imports are pulling the rug out from under us in such U.S. industries as steel, copper, textiles, and footwear, I would urge the members of this subcommittee, indeed the entire Congress, to heed at least partially the preachings of Shakespeare's admonition to Brutus, that the fault is not in our stars but in ourselves.

The United States is still the leader of the free world in the realm of trade, and despite the trade deficit our exports were good for us and good for our allies, particularly Japan last year. For example, we exported $38 billion worth of agricultural goods. I can concede that it would be desirable for us to export more. I also concede that many of our trading partners, including Japan, deserve reproach for their resistance to open their markets to our imports and that it would be appropriate for us to take meaningful action vis-a-vis any nation with policies which impede free trade.

However, I also believe we must address all of the factors which have contributed to the rapidly deteriorating trade situation.

First and foremost is the problem of the exchange rates. Few dispute the fact that the strong dollar is a major cause of the trade problem. As a result, American goods cost more abroad and foreign goods, because they are cheaper here, march through our economy like Napoleonic armies.

Second, while the dollar has been preening in its tuxedo overseas, it has forced upwards U.S. interest rates. This has made it very convenient for our trading partners to lend money accumulated from their excess imports and domestic savings to the U.S. Government rather than buy goods and services in our economy.

Why are our trading partners following this course of action? It's because of the third and most important factor underlying our current trade deficit: our profligacy at home in the form of enormous domestic deficits. Our Government is on a binge of borrowing and spending which in turn push up interest rates and sucks in investment capital from all over the world. While Government deficits may have provided the stimulus to pull the country out of the last recession, they now have sown the seeds for the destruction of all that has so recently been achieved in terms of inflation, employment, productivity, and growing per capita incomes.

Ironically, Congress has at its disposal perhaps the most effective tool to enhance our trade position. Congress should have the courage to reduce spending and the deficit, thereby easing interest rates which have produced the overly strong dollar and this unsavory condition.

A lower Federal deficit is not only the best way to nurture the recent improvements in the American economy, but also the key to improve the ability of U.S. companies to compete in world markets, including those of Japan.

I should note that Chairman Volcker, the Federal Reserve Board, also supports this approach.

Sadly, instead of facing its responsibilities and acting to correct the trade deficit, Congress has chosen to lash out at other governments, particularly its closest allies, with such protectionist proposals as import surcharges, domestic content requirements, and import ceilings.

Protectionist measures can only hurt Americans. We invite, and I believe, indeed, encourage retaliation on the part of our trading partners and that retaliation will have a far more detrimental effect than we are now experiencing.

In addition to congressional action reducing Federal spending, I believe there are other appropriate and effective steps for us to take. For example, it's obvious that the GATT system is not working from the American viewpoint, particularly with respect to Japan. Japan has been loathe to lift its regulatory restrictions on imports and to recognize American manufacturers' rights to sell products in that country free of traditional discrimination. However, if the system is flawed, then the more appropriate route is to take steps to strengthen it. If this entails applying pressure during negotiations, then let us take that action rather than closing our market doors altogether.

We need to give the highest priority in our national policies to improving and enhancing the competitiveness of our economy. I am convinced, however, that the best policy is one which promotes open markets for everyone rather than one which strikes out at recalcitrant players in the world market. If we choose the latter course and bash the so-called bad guys, we do nothing more than bash ourselves.

Thank you, Mr. Chairman.

Chairman LaFalce. Thank you very much.

Our first witness today who has some time constraints is, as I said before, Lionel H. Olmer, the Under Secretary of Commerce for International Trade.

Mr. Olmer, we have the entire text of your testimony. We will incorporate that in the record. You may read it or you may summarize it as you wish.

STATEMENT OF HON. LIONEL H. OLMER, UNDER SECRETARY OF COMMERCE FOR INTERNATIONAL TRADE

Mr. OLMER. Thank you, Mr. Chairman. I would like to briefly summarize my statement which has been submitted for the record and begin by expressing appreciation for the opportunity to testify before your subcommittee today.

You and Mr. Shumway have identified some of the barriers which U.S. exporters face in Japan. They are indeed varied and complex. I've tried to identify some of the specific types both formal and informal, structural and traditional, and to describe the direct and indirect ways in which these affect the competitiveness of U.S. industry.

Some of the barriers maintained by Japan, such as GATT illegal quotas, are clearly wrong, but those in the instance of Japan happen to be very few. Others, such as government plans which detail capacity reductions in depressed industries, are not illegal under any current internationally agreed upon system, but they are indisputably different in ways detrimental to our interests.

The question remains whether we can continue to avoid serious trade conflict when our two countries are playing by somewhat different rules that happen to differ in fundamentally important ways. There are, for example, 500 legal cartels in Japan and 21 industries which are privileged because they are labeled as depressed and they therefore receive special treatment.

Although Japan certainly has come a long way since the 1960's in dismantling its more apparent trade barriers, we are still confronting a number of trade distorting effects of past practices.

It is true, for example, that the Japanese Government has reduced its tariffs on machine tools to zero and has rescinded explicit government directives prohibiting imports. It's also true that during a very key period in the machine tool industry's development, the Japanese Government's involvement determined the future outcome. That's happened in a number of different industries.

The competitive effects of Japanese trade barriers go far beyond the one-shot failure of an American corporation to make a sale to a Japanese customer. Japan is the second largest economy in the free world and it's a major consumer of high technology products on which U.S. industrial competitiveness depends.

Without access to the Japanese market, our industries cannot be competitive at home or Japan or elsewhere in the world. The obverse is also true. Volume sales in the wide open U.S. market for semiconductors, telecommunications equipment, machine tools, all help to keep Japanese industry competitive.

These factors provide an added dimension of difficulty and, in a way of speaking, a special urgency to our efforts to open the Japanese market.

As you've described them, Mr. Chairman, past Japanese trade packages have tended to focus on traditional trade barriers such as tariffs or on limited product-specific problems.

Prime Minister Nakasone's strong public appeal just a few weeks ago was a very significant departure from this precedent. It emphasized the urgency of the problems caused by Japan's low propensity to import, especially manufactured goods, and on the need for attitudinal and policy changes toward foreign products. That statement, plus several of the Okita Committee recommendations, evidenced that at the very highest political levels in Japan there is a clear understanding that our problem is much broader than merely traditional trade barriers.

For the Prime Minister's initiative and the Okita's Committee's work to make a real difference, there has got to be effective followup in Japan and I would like to say that I think there are encouraging signs.

The Ministry of International Trade and Industry has already met with 60 major Japanese exporting companies on ways to implement the Prime Minister's call to import more. A new organization will coordinate these efforts under the direct guidance of the Prime Minister. Publicity on the central theme of buying foreign manufactured products is continuing, and, I might say, to the best of my ability to discern it, is accelerating.

Most important, these new measures are not being sold to the Japanese public as a distasteful, albeit necessary, response to foreign pressure. The Prime Minister has made it clear that these steps are urgently needed in Japan's own self-interest. Continued Japanese access to foreign markets depends on more balanced trade, which in turn depends on increased Japanese imports. It's a simple but critical equation which the Japanese people, I believe, are prepared to accept, particularly with the government's continuing encouragement.

The second aspect of the Prime Minister's April 9 announcement which does have significant potential is the commitment to draft a 3-year program to improve market access. We have to be encouraged by the announcement that the Okita Committee's recommendations will be given fullest consideration in formulating the program. Some of the more important recommendations are worth commenting on here.

First and foremost is stimulation of domestic demand to decrease reliance on exports and, assuming the absence of trade barriers, stimulating imports. Second, freedom from restrictions—that is, the elimination of unjustified governmental interference, and a requirement that remaining restrictions, even those for structural adjustment in those 21 depressed industries, must be justified in accordance with international rules. Third, liberalization of the service industries, particularly in the financial area. Fourth, reassessment of a Japanese practice that we have long considered onerous; that of single tendering. Reduced reliance on single tendering would enhance foreign access to the entirety of the government procurement structure. Finally, a reexamination of tariffs in agriculture, forestry and fisheries. Action in these sensitive political sectors, sensitive in the Japanese context, would send an important signal that Japan has indeed committed itself to opening its economy to foreign competition.

We're going to have to wait until July for details on the action program, but I believe it's going to be serious and that it will be a committed effort to solve longstanding problems.

Perhaps the most important, far-reaching aspect of the Prime Minister's commitment is his agreement to the intense sectoral negotiations that we have been conducting since January of this year, the aim of which is to liberalize entire sectors of the Japanese economy.

In the past, most often, we would negotiate the removal of one barrier to a product's entry, such as a tariff, only to find many other barriers such as standards or cartel-like behavior blocking sales. Under the concept embraced by the Prime Minister at his meeting with the President in January in Los Angeles, all barriers in these sectors—traditional barriers, structural barriers, direct and indirect barriers—are on the table. The objective is to open complete sectors, not just individual products, to fair competition.

We have completed successfully the first phase of our telecommunications talks—and I want to emphasize "our first phase." And we are going now to proceed to the second phase.

In other sectors, such as pharmaceuticals and medical equipment, forest products and electronics, we are in the initial phases of discussion but some progress can be measured.

In medical equipment, inroads have been achieved on the previous blanket refusal by the Japanese Government to accept foreign clinical test data. There are still several important areas where duplicate testing in Japan on Japanese patients may be required and undoubtedly instances where that requirement will delay market entry by highly competitive U.S. products. But the first, most difficult steps have been taken by several different Japanese ministries.

In electronics, we have dealt with several major barriers. Japan has proposed legislation to provide protection for semiconductor designs. Legislation to enhance copyright protection for software is also in the works. We are discussing the mutual elimination of tariffs on computer parts and other tariff concessions on many additional electronic products.

We still have ahead of us, however, serious problems of access for many component parts of the electronics sector, and we believe that there may well be unfair Government computer procurement practices which require examination.

I would like to end on a somewhat personal note. I have served as Under Secretary for nearly 4½ years and will soon be leaving the administration. Because of my past experience and continuing personal interest in Japan, as well as the pressing reality of our $37 billion deficit, I have devoted a high proportion of my attention to this problem.

Mr. Chairman, while you were giving your opening statement, what came to my mind is that early in the spring of 1981 when I was young and naive and didn't have this much gray hair, I gave a speech in New York to a number of Japanese businessmen and bankers and I said that if imports and exports increased at the approximate rate they were then increasing roughly 17 percent a year, that by 1990 or before the end of this decade we would have a $50 billion trade deficit and that would be politically unacceptable.

Now the gentleman in charge of the Japanese side of this seminar in New York was none other than Saboru Okita, who has now made these rather forthcoming recommendations to his government for increasing imports.

At that time he said, "That is simply a straightline economic projection and it doesn't square with any reputable economic analysis" with which he was familiar with. And I said, "I'm not an economist; I'm an honest man, and it does seem to me that that is a reality that we should give some thought to."

It seems to me that while we had a $37 billion deficit with Japan in 1984, we are well on our way to coming close to $50 billion well before the end of this decade, and that's a most serious matter.

My conclusion is that we've had slow going over the first 3 years of this period. In the past year and a half we have made remarkable progress in some sectors. The telecommunications agreement, even though it does not yet deal with all of the market opening measures necessary—and I underscore that "necessary"—for our industry, is nevertheless a milestone.

The Prime Minister's agreement to engage in negotiations to produce structural change in entire sectors of the Japanese economy is historic. His personal stake in this is unprecedented.

Now between 1979 and 1981, our manufactured exports to Japan increased by roughly 50 percent. The problem is, however, that Japan's more than doubled and we've got to strike a better balance in that process. A lot more needs to be done. I have some, what I would describe as, cautious confidence that the environment has been changed in ways which will give an even playing field to our companies.

With your help in monitoring this process, Mr. Chairman, we might come very close to achieving our complete objectives.

Thank you.

[The prepared statement of Mr. Olmer follows:]

TESTIMONY OF

LIONEL H. OLMER

UNDERSECRETARY OF COMMERCE

FOR

INTERNATIONAL TRADE

BEFORE

SUBCOMMITTEE ON ECONOMIC STABILIZATION

APRIL 30, 1985

I appreciate this opportunity to testify today regarding access to the Japanese market for U.S. goods and services.

TRADE BARRIERS

I have not submitted a comprehensive list of specific barriers, but intend to explore general classes of government action which have trade limiting or distorting effects--and to assess their implications for U.S. trade and industrial competitiveness.

Formal Barriers

The most obvious barriers to market access are the formal restrictions. These include tariffs, import quotas, investment screening laws, foreign exchange regulations, state monopolies, and preferential procurement requirements, among others. The incidence of such barriers is obvious, as is their effect on imports: Foreign sales are precluded, limited, or forced to bear a clear price disadvantage.

Since the 1960's, Japan has made substantial progress in reducing these formal barriers. Tariffs are generally low. Monopolies such as Nippon Telephone and Telegraph and Japan Tobacco and Salt have been "privatized", and although it is too early in this process to determine whether privatization will soon make a difference in terms of access for American suppliers, I believe it ultimately will. Foreign exchange and investment restrictions have been largely eliminated, although pre-notification for foreign investment is still required. This means that potential investors still have to advise the Ministry of Finance in advance of their plans, and still run the risk of government interference--formal or informal.

While the scope of formal trade barriers has been reduced, those which remain are sharply targetted on competitive imports.

- Tariffs impede our ability to sell wood, paper, some fisheries, aluminum, chocolate and numerous petrochemical products.
- Quotas on fisheries, leather and footwear, and agricultural items limit sales (despite recent quota expansions).
- Widespread single tendering on government contracts undercuts our rights under the Government Procurement Code, and reserves a part of the market to inside suppliers.

Indirect Barriers

Less obvious, indirect barriers are pervasive. Their effect is substantial, although they often result from domestic policies which developed independent of trade considerations, such as a desire to protect the Japanese people from potentially dangerous or ineffective drugs.

Perhaps the most significant indirect trade barriers are Japanese government industrial policies. These policies are based on the notion that the government has a broad responsibility to oversee the development of infant industries; to underwrite the restructuring of industries caught in cyclical recession or structural decline; or even to provide long-term protection to industries which may never again regain competitiveness.

The effect of such policies is to insulate broad sectors of Japanese industry from the full play of market forces, often for extended periods of time. The prohibition on procurement of foreign telecommunications satellites is the most recent example. Other, less obvious actions may have the same effect.

-For industries threatened by import competition, trade liberalization is avoided completely or only minor concessions are given.
-In high technology industries, research efforts are coordinated and undertaken jointly under government guidance. Research results are protected and licenses may not be granted without prior government approval.
-In depressed industries, cartels are formed to coordinate capacity reduction in line with long-term government demand/supply forecasts--forecasts which take virtually no account of imports. Incidentally, in the free world's second largest economy, one with a world-wide $34 billion surplus, there are over 500 legal cartels and 21 offically designated structurally depressed industries entitled to protection.

Whatever the instrument, the results are the same: Import market shares remain abnormally low.

Another broad category of trade problem results from the view in Japan that the government has a role in protecting the consumer and that this requires intervention. This produces an often impenetrable maze of regulations which deters market entry--by Japanese and foreign firms alike. Telecommunications is a case in point: the bilateral telecommunications talks, which are still continuing, were prompted by the burdens which the regulatory system as originally proposed under the Telecommunications Business Law, would have placed on foreign firms seeking to enter Japan.

Our telecommunications negotiations have been largely successful. The regulatory system has been trimmed significantly. Japanese standards have been reduced to a level close to those in the U.S. Yet we encounter just such problems in other fields, such as medical and pharmaceutical testing and approval. It is a pervasive problem that results indirectly from often well-intentioned policies.

Stringent government regulation has also been a problem for U.S. service industries. Only after intense consultations did we secure Japanese Government assent to allow the passage of "high cube" containers on Japanese roads. The yen/dollar accord is helping to break down restrictions in Japanese financial markets.

There are also private barriers to U.S. service firms. The Japanese Federation of Bar Associations continues to oppose foreign lawyers practicing in Japan. Japan Tobacco is only now completing a three-year test for tobacco shipments by U.S. carriers.

Structural Barriers

Structural barriers to market entry are even more removed from our traditional concept of tariffs and NTB's. Many of these are long-standing practices which were not intended to discriminate against foreign products. They often act equally as a deterrent to Japanese domestic firms seeking to expand into a sector dominated by a firmly established group of companies.

Some of the most difficult structural problems stem from established relationships. Within the keiretsu groups, there is a natural inclination to source purchases from other members. Financial institutions have a strong interest in helping unprofitable members through difficult times. Entry into these closed circles is difficult for both foreign and domestic newcomers.

For industrial procurement, sub-contractor relationships are also a barrier. Subcontractors frequently take up the slack for their larger customers in a downturn. This loyalty is rewarded--and justified--by the certainty of a protected supplier position.

The distribution system may also be a problem for a foreign supplier. It is very difficult and expensive for foreign firms to set up their own network. Japanese distributors often have close personal ties or even equity and stock ties to their Japanese suppliers. Either choice--begin a separate channel or go through established intermediaries--has its drawbacks.

LATEST JAPANESE ACTIONS

Past Japanese "trade packages" have tended to focus on traditional trade barriers--such as tariffs--or limited, product-specific problems. Prime Minister Nakasone's strong public appeal on April 9 was a significant departure from this precedent. It emphasized the urgency of the problems caused by Japan's low propensity to import and the need for attitudinal and policy changes toward foreign products. This statement--plus several of the Okita Committee recommendations--evidence that, at the top political levels in Japan, there is a clear understanding that our problem is much broader than just traditional trade barriers.

For the Prime Minister's initiative and the Okita Committee's work to make a real difference, there must be effective follow-up in Japan. There are encouraging signs:

-MITI has met with 60 major Japanese exporting companies on ways to implement the Prime Minister's call.
-a new organization, the External Economic Measures Promotion Headquarters, will coordinate these efforts under the direct guidance of Prime Minister Nakasone.
-publicity on the central theme of buying foreign products is continuing.

But most important, these new measures are not being sold to the Japanese public as a distasteful but necessary response to foreign pressure. The Prime Minister has made it clear that these steps are urgently needed in Japan's own interest. Continued Japanese access to foreign markets depends on more balanced trade--which in turn depends on increased Japanese imports. It is a simple but critical equation, which the Japanese people appear prepared to accept.

The second aspect of the April 9 announcement which has significant potential is the commitment to draft a three year program to improve market access. I am encouraged by the announcement that the Okita Committee recommendations will be given fullest consideration in formulating this program. The committee's more important recommendations include the following:

o -stimulation of domestic demand--to decrease reliance on exports and, assuming the absence of trade barriers, stimulate imports.

- -freedom from restriction--elimination of unjustified governmental interference and a requirement that remaining restrictions, even those for structural adjustment, must be justified internationally.
- -liberalization of service industries--particularly in financial areas.
- -reassessment of single tendering--reduced reliance on single tendering would enhance foreign access to the entire government procurement structure.
- -reexamination of tariffs in agriculture, forestry and fisheries--action in these sensitive political sectors would send an important signal that Japan is indeed committed to opening its economy to foreign competition.

We will have to wait until July for details on the program, but the foregoing outline suggests that it will be a serious, committed effort to solve our long-standing problems.

SECTORAL DISCUSSIONS

Probably the most far-reaching of Prime Minister Nakasone's commitments is his agreement to intensive sectoral negotiations whose specific aim is to liberalize whole sectors of the Japanese economy. In the past, too often we would negotiate removal of one barrier to a product's entry--such as a tariff--only to find other barriers--such as standards or cartel behavior--blocked sales. Under a concept embraced by the Prime Minister, all barriers in a sector--traditional, structural, direct, indirect--are on the table. The objective is to open complete sectors--not just individual products--to competition.

The sectors are specifically those in which U.S. firms are proven international competitors, but our market shares in Japan are abnormally low. We have completed successfully the first phase of our telecommunications talks and are proceeding to phase two. In the other sectors we are in the initial phases of discussion, but we have already made some progress.

-In medical equipment, inroads have been achieved on the previous blanket refusal by the Japanese to accept foreign clinical test data. There are still several important areas where duplicate testing--in Japan on Japanese patients--may be required, and undoubtedly, instances where this requirement will delay market entry by highly competitive U.S. products, but the first, most difficult steps have been taken.

-In electronics, we have already dealt with several major barriers. Japan has proposed legislation to provide protection to semiconductor designs. Legislation to enhance copyright protection for software is in the works. We are discussing the mutual elimination of tariffs on computer parts and some other tarriff concessions on other electronics products. But we still have ahead of us serious problems of access for our semiconductor industry, and what we believe may be unfair government computer procurement practices.

CONCLUSION

Permit me to end on a personal note. I have served as Under Secretary for International Trade for nearly four and a half years. Because of my past experience and continuing personal interest in Japan--as well as the pressing reality of our $37 billion deficit--I have devoted a high proportion of my attention to this problem.

My conclusion is that, while we have had slow going over the first three years of this period, in the past year and a half, we have made remarkable progress in certain sectors. Our telecommunications agreement, even though it does not yet deal with all of the market opening measures necessary for our entire industry, is nonetheless a milestone. The Prime Minister's agreement to engage in negotiations to produce structural change in whole sectors of the Japanese economy is historic. His personal stake in this process is unprecedented.

So much, much more needs to be done--I have some cautious confidence that the environment has been changed in ways which will make needed changes more possible.

Id #1622

Chairman **LaFalce**. Thank you very much, Mr. Olmer, for an excellent opening statement.

This subcommittee intends to give you as much help as you need in monitoring this process. As a matter of fact, when you appeared informally before this subcommittee in March, it was my impression that you were not as sanguine about the prospects for dealing with the Japanese. Indeed, I think you termed their conduct virtually outrageous when it came to negotiations and discussions.

Subsequent to that, in late March and very early April, especially after April 1, the day of the privatization of their telephone system and the day of the lifting of our voluntary restraints on automobiles, the Congress engaged in a more confrontational mode with the Japanese. I have several questions.

First, don't you agree that most of the progress that you have witnessed with Japan in opening up their trade barriers has been since April 1 of this year?

Mr. **Olmer**. Yes.

Chairman **LaFalce**. Second, while I perhaps shouldn't push you to establish a cause and effect relationship, don't you think that the fact that the U.S. Congress has displayed its ire at the Japanese trade barriers, that that may well have been helpful in getting them to display a greater openness to our perspective regarding their barriers?

Mr. **Olmer**. Without question.

Chairman **LaFalce**. Now that makes me hopeful and fearful at one and the same time—hopeful that they have been responsive, fearful that if we ever stopped engaging in that type of discussion, that they might ease off and go back to their previous practices.

I am also concerned, too, because while I have personal confidence in the disposition and integrity of Mr. Nakasone, I am doubtful about the impact that he might have upon the total Japanese system. I'm just not sure how much he or anybody in his position in Japan would be able to move that system, developed as it has over decades and centuries.

Do you share my concern?

Mr. **Olmer**. It needs a little amplification, Mr. Chairman. In the first instance, as we achieve structural change, we are going to build a constituency among the Japanese people that politicians will not be able to reverse. That is in part to say that the Japanese consumer, not only the private citizen but also businesses in Japan, do not have access to, for example, the latest state-of-the-art in the telecommunications industry, in the new information age technology.

It isn't that Japanese companies are incapable of producing such goods. It's been that their government has emphasized export push and import restraint, and the customer in Japan simply doesn't have access to what an American business or a European business does.

As those kinds of barriers are broken down, I don't think that can be reversed very quickly.

The other thing is that many of the kinds of barriers that we are talking about that have prevented U.S. companies from making sales were not erected for the purpose of keeping an American company out. Let me give you a specific example.

A unique American company that I happen to consider a national treasure in a way was almost successful in making a sale of a supercomputer to a Japanese automobile company. That Japanese automobile company wanted to buy it, said there was no other computer that could do the job that needed doing, and did everything proximate to consummating the purchase. And then it called the American company and said, "No, I can't do it because I am a member of the Hitachi group and Hitachi wants to sell and I have to follow those strong tie inclinations."

Now that was not put there to keep the American corporation out, and my guess is that if it was Fujitsu, the same answer would have been given, or maybe Fujitsu would have understood that it shouldn't have even tried.

Now I am not suggesting that that's an acceptable barrier. I am suggesting that it wasn't placed there by the Government and it wasn't placed there just to keep Americans out. It's just as important that we root it out, prevent it from occurring in a way detrimental to the interest of American corporations, but it's a very complicated series of issues that we are dealing with.

Chairman LaFalce. I understand, but one point that I want to make is, it's one thing to understand and it's another thing to accept. If they want us to understand that their mentality would require them in that example to buy from Hitachi, they then would have to understand that our mentality would require us to reciprocate in some other type of trade barrier to their goods, even though we wouldn't want to. The mentality of defending yourself is getting stronger and stronger, and if they don't want us to defend ourselves against that, they are going to have to come to some type of greater understanding.

Now Mr. Shumway and I probably came forth with pretty much the same facts but with different tone. I said clearly a large portion, and perhaps the chief portion, of the blame could be laid here in the United States, either with governmental or private sector practices. That's a given. We have had countless hearings on that issue about making the U.S. industries more competitive.

Today's hearing is about a separate problem, though yet still a real problem.

So I want to ask you, assuming that we were able to eliminate the formal and informal barriers, I said that the Department of Commerce had estimated that we might be able to reduce the trade deficit with Japan by approximately $12 billion. Is that a fair estimate?

Mr. Olmer. Yes, sir. That's an approximation and it's the best we are able to come up with.

Chairman LaFalce. OK. So it is a Commerce Department approximation?

Mr. Olmer. It is a Commerce Department approximation.

Mr. Chairman, might I clarify a point that, as I reflect on, I may not have made as clear in a one-word response to your question in my effort to be brief. I believe you asked whether or not all progress or substantially all of the progress that's been made in telecommunications occurred from the first of April.

Chairman LaFalce. I didn't say all; I said most of the progress.

Mr. OLMER. I don't want to take anything at all away from the intensity of the congressional interest in this issue as an inducement to the process of negotiating, but a lot was set in motion in February and March, and part of the kind of behavior that I did describe to you that I personally found offensive and unacceptable rather quickly disappeared beginning in mid-March, late-March, although it wasn't yet discernible. By the first of April when that law went into effect, we had by then substantially achieved our negotiating objectives.

We followed that up.

Chairman LAFALCE. We're talking about 2 or 3 days before April 1, as I recall.

Mr. OLMER. Exactly.

Chairman LAFALCE. We're talking about February or March, spending most of your time trying to translate Japanese regulations given to you in Japanese that took about 50 percent of your budget just to translate, and you couldn't begin the negotiations with them until you had finished the translation and you weren't even able to do that until the very end of March. Is that correct?

Mr. OLMER. Absolutely.

Chairman LAFALCE. Thank you.

Now this remarkable progress that you have made in large part since a few days before April 1st to the present, that's only one stage though. You said that when it comes to particular sectors they have many different forms of barriers. There's a first stage barrier, a second stage barrier, a third stage barrier, and so forth.

Now with telecommunications, how many phases are we through and how many phases do we yet have to go through, would you say?

Mr. OLMER. I described for the Japanese my analysis of the telecommunications sector as roughly divided into three component parts. We have achieved substantially all of our objectives in the first part, and that first part was conditioned for us by the April 1 date on which the Japanese were implementing their new law creating a private company out of a previous government monopoly, and providing a legal framework for the provision of telecommunications services.

But there remain enormous market opportunities for telecommunication products in the field of radio. There remain very substantial market opportunities for American goods and services in what we call common carrier. And there also remain obligations on our part to follow up on what we understand the commitments to have been in the area that I've said to you I believe we have achieved our objectives. I hope that we will complete this entire effort within the next few months. We have begun. We have laid out the problems to the Japanese in a letter which I have submitted to the vice president.

Chairman LAFALCE. I am fearful of a number of things, Mr. Olmer. No. 1, that we could have been given a pacifier and once we've been given a pacifier it's going to be difficult to get any real meat. What about important phase 2's and phase 3's? They are the things that concern me and two things that are both personal.

First, our U.S. Trade Representative, Bill Brock, who had achieved great credibility with the U.S. Congress and in the international trading community, who knew the lay of the land, who knew what had to be negotiated, who knew how to negotiate, was pulled out as Special Trade Representative in order to solve some political problems and sent over to the Labor Department.

Second, you, who have been leading the negotiations for the Commerce Department since 1981 when you were considerably younger, but I doubt naive——

Mr. **Olmer**. At least 4 years ago.

Chairman **LaFalce**. How much grayer, I don't know. You're going to be leaving, and I think we're going to have a real void after June 1, both with Bill Brock and with you gone.

So I think there's going to be tremendous obligation on the shoulders of the Congress to make sure that what we have started doesn't stop. I am really fearful, though, that we don't have too much of a game plan for these future negotiations. I hope that between now and the time of your departure you will lay out a game plan for all the negotiations you think must be conducted until we resolve this overall United States-Japanese difficulty.

Mr. **Olmer**. Mr. Chairman, let me say that I know Clayton Yeutter personally and pretty well, and I just have absolute confidence in his ability to assume these responsibilities without any lost time in a learning process. He knows the job now, and he's well acquainted with our problems with Japan as well as our opportunities in Japan, and that's been evident in his private sector experience as well.

Chairman **LaFalce**. He may be the best in the world. We don't know that. I don't know that our trading competitors know that. Negotiations so often do require some credibility. Who, by the way, is going to be your successor? Has that been determined yet?

Mr. **Olmer**. It has not yet been announced. I hope that there will be an announcement within the next couple weeks and, again, I leave with great confidence that with your watchfulness, Mr. Chairman, and the kinds of people the President has selected to carry on, we won't lose any time.

Chairman **LaFalce**. With all this confidence, we'd better be careful.

Mr. Shumway.

Mr. **Shumway**. Thank you, Mr. Chairman.

Mr. Olmer, at the beginning remarks of your testimony you pointed to the fact that there are some requirements which have been put up by the Japanese, perhaps imposed in some degree of national self-interest, but which in and of themselves are not illegal. They don't contravene anything in the GATT or other international trade agreements.

I suppose we have loosely referred to those requirements in the past as nontariff trade barriers or some other descriptive term. Are you suggesting that maybe the GATT should be strengthened to make illegal those things that heretofor have been legal, or do you not make any recommendation in that regard?

Mr. **Olmer**. Well, I share your view entirely that the GATT system needs to be strengthened, that it has not proven itself adequate to the tasks, for example, of problem resolution, and in that particular area—dispute settlement—it needs desperately to be strengthened.

I wouldn't want to put the issue with regard to Japan in a legal-illegal context, but suggest that there are some practices which are simply not covered, as in services, as in high technology. And those are the very things that the President has been most strong regarding putting on the agenda for a new trade round.

I do believe that that absolutely needs to be done.

Mr. SHUMWAY. Well, then they should be covered in the GATT or some similar agreement?

Mr. OLMER. Sure.

Mr. SHUMWAY. Not left to simple negotiations or perhaps the whim of Congress moving in a void?

Mr. OLMER. I do believe codes need to be established for international behavior in those kinds of areas, absolutely.

Mr. SHUMWAY. Another problem that sticks in my mind—you described very well the status of imports and exports on both sides of the Pacific, and, particularly, even though there have been perhaps some modest increases in our exports to Japan, we are now importing more from that country, more than double what we were in the period that you cited.

Do you believe that that should give rise to perhaps some kind of effort in this country that maybe the other side of the coin that is now being pursued by Prime Minister Nakasone? As I understand, his ambition in Japan is to get the Japanese to buy more foreign products in an effort to alleviate that problem. Should we have a similar kind of effort underway in America which perhaps would say buy more American products and less imported products and, if so, would that help at all in this particular problem?

Mr. OLMER. I don't agree with that formulation. I believe in an open and free trading system which enables a consumer to make a choice from as wide a variety as can possibly be put before him or her so long as those goods have been traded in accordance with international rules that deal with free and fair trade.

That's a long, complicated perhaps convoluted sentence, but included in that free choice, as the Congress has seen fit to legislate, will be labels on American apparel products which will indicate "Made in America." I have no quarrel with that kind of formulation, but I would not want and don't believe there is a need to go out and promote the purchase of American goods and the avoidance of the purchase of foreign goods.

Mr. SHUMWAY. The aspect of that problem that I guess sticks with me is that it seems to me that those industries in America that are hurt the most by competition here in America with Japanese goods will be the ones perhaps least affected by some change in Japan's policy regarding imports.

For example, if Japan decides to open its doors wider, let's say, which we all want to see accomplished, I can't really see that as providing more opportunity to sell more automobiles made in the United States in Japan. Consequently, the auto industry and many like it that are very much hampered by that Japanese competition here are really not going to be benefited by that particular kind of move.

Do you see that as a problem?

Mr. OLMER. Well, it clearly is a matter which requires us to avoid any sectoral reciprocity per se, clearly. But some Japanese are fond of saying, "Americans insisted on putting the steering wheel on the left-hand side and that's why they couldn't sell more cars in Japan." And I view that as trivial nonsense, partly because for nearly 2 years I drove an American left-hand wheel car in Japan by myself and had no difficulty and must have had 150 offers to purchase it. This was in the old days when the Japanese weren't manufacturing their own automobiles and at a time when a major American producer of automobiles was doing very well selling cars with right-hand drive in Britain and those cars couldn't get into Japan either. That was the infant industry concept that we need to fight.

The other issue that we need to fight is the avoidance of accepting the Japanese argument that it is the relationship between the two currencies that prevents American goods from being competitive. You can look at purchases of American semiconductors and find that the market penetration has remained stable at about 10 percent irrespective of the relationship between the yen and the dollar. I daresay there are a number of other American products and entire American industries which have experienced that kind of thing. That is, that it has been a desire to keep out foreign products or it has been the confluence of personal relationships and government policy that has prevented American companies from asserting the kind of competitiveness that we think in an even playing field they could.

Mr. **Shumway**. Finally, let me just ask what is your opinion, if you would voice it to this subcommittee, regarding the proposal to impose a 20-percent surcharge on Japanese imports if Japan does not show more willingness to open her markets to American exporters?

Mr. **Olmer**. I don't agree with it. I know the administration does not agree with it. I believe it would hurt us worse than it would hurt the Japanese, and I doubt that it would do anything except possibly—and this isn't even a certainty—in the short run making a contribution to budget reduction. But that's not the way to reduce the budget deficit and it certainly isn't the way to promote freer trade in the world. It would invite retaliation. It would encourage a whole host of other countries to rise up and say, "Well, look, if the United States which has been the leader in espousing freer trade has given up in effect, why should we not give up and just keep American goods out?"

You know, we do dominate other markets in a number of different foreign countries, we think for the right reasons, and some countries have taken steps or would like to take steps to keep us out. I think they would be encouraged by seeing American action in that regard.

Mr. **Shumway**. Thank you, Mr. Olmer.

Chairman **LaFalce**. Mr. Torres.

Mr. **Torres**. Thank you, Mr. Chairman.

I wanted to pursue just very briefly the line of questioning that Chairman LaFalce had initially discussed relative to structural changes.

You mentioned in your very eloquent statement that you had had a lot of experience. You cited your personal involvement, your years of experience before the gray hair, so to speak. I take it that you know the Japanese structural and cultural conditions; you have worked with the representatives of this country for a long time.

You mention in your statement the Prime Minister's agreement to engage in negotiations to produce structural changes in whole sectors of the Japanese economy as being a very historic step. His own personal stake, you indicated, is unprecedented in this issue.

And earlier you mentioned that the Prime Minister had made it clear that these steps are urgently needed in Japan's own interest. You cited continued Japanese access to foreign markets depends on more balanced trade which in turn depends on increased Japanese imports.

U.S.-made automobiles, for one, is an area of vital interest to me and many of my colleagues. It appears that it is a simple but critical equation, you say, which the Japanese people appear prepared to accept. And based on your experience and based on your statement, you said, "which I believe"—you said, "I believe."

What leads you to believe this? And perhaps you could elaborate a little bit on that.

Mr. OLMER. Mr. Torres, you mean what makes me believe that we can build a constituency in Japan that would encourage this?

Mr. TORRES. Exactly; yes.

Mr. OLMER. Partly because businessmen in Japan have often been held hostage to Japanese Government interventionist policy. Many Japanese bureaucrats will describe the authority that law and procedure—regulations, ministerial regulations—give them as in effect saying, "You have been put in your job in the government in order to determine the rate at which Japanese consumers"—that is the buying public as well as businesses—"can absorb new technology, new products, and freer choice."

We went through that exact process in the effort to eliminate most of the technical requirements which would prevent foreign-made telecommunications products from entering the Japanese market. Under a Japanese formulation that said, in effect, the Ministry of Posts and Telecommunications shall have the right to determine whether or not the Japanese consumer is ready, whether or not the Japanese consumers interests are being sufficiently provided for in terms of a specific product.

I think once we start this process, as we have been given substantial encouragement in telecommunications, we indeed will build a constituency and it isn't for fondue pots and oven thermometers, but it is for large-scale American-provided computers, telecommunications devices, medical equipment, pharmaceuticals, and even forestry products.

Now regarding the one industrial sector you mentioned, automobiles, I know that American companies can be competitive in providing automotive parts. I just know it. I know they can provide original equipment in Japan and I know that they can compete successfully here against Japanese imports. And I think we've got to work constantly on that to develop constituencies and to eliminate preferential buying within the Keiretsu or the industrial groupings of Japanese companies and banks, and we can do it with the encouragement of the Japanese Government, and I would not want to leave out of the equation the watchful eye of Chairman La-

Falce, as well as one or two other Congressmen who have expressed themselves on the issue.

Mr. **Torres**. Thank you, Mr. Secretary.

Mr. Chairman, I have no further questions.

Chairman **LaFalce**. The return of the prodigal son, Representative McKinney.

Mr. **McKinney**. Mr. Chairman, it's nice to be here and I would particularly say it's nice to see Mr. Olmer who I think has done an incredibly good job against the most straining of circumstances, whether it's the straining of the patience, the straining of the face from constantly smiling, or what.

A few things I think bother me just in general, and we are going to miss you, by the way, Mr. Olmer. A few things bother me just in general which I want to cover. I don't think ever before in my history in this body have I seen such a—I think the best way to describe it is—rage on the part of the general Congress, and I have had quite a set-to in the past with my good friend, the U.S. Trade Representative, Mr. Brock, and said,

> You know, you've got to stop talking to my good friends on the Ways and Means Committee and you'd better start talking to the rest of the Congress of the United States because there's something happening up on that Hill.

I have this nightmare of Congress not being able to really wrestle with the budget and some Congressman dashing forth in the depressed northeastern or midwestern industrial area and saying, "I've solved the problem. I can raise $60 billion and never have it cost the American taxpayers a dime. I'll just put a surcharge on Japanese imports."

I thought this is pretty ridiculous, this nightmare I'm having, so I checked with my little computer. There are bills all over this Hill to not just merely tax but to, in essence, slam, beat and mutilate the Japanese. And I am not so sure that I really restrain myself very well either—but anyway, I just think it's a point that's got to be made, that the situation legislatively is far more serious than I think the trade representative's offices thought it, and I would hope, since you are aware of it, I am convinced that you will tell your successor that this is a real problem and a lot of work has got to be done.

What do we do with GATT, which to me became superfluous years ago. It became superfluous because the British Government, say, with the A-300 with the Rolls Royce engine started to use credit. The French decided they would use currency reorganization or what have you, or the value-added tax. The Japanese decided they would use their tax system and their undervalued currency.

What do we do to say, "Hey, look, it may not be the Smoot-Hawley, it may not be the tariff barrier, it may not be the proscriptive rules, it may not be procedural law, but every weapon possible is being used on 'Uncle Sucker' " and we are saying, "No, we're going to live up to GATT."

I just wonder, aren't we really talking about a much more total agreement that we are going to have to make to replace GATT to cover things like Government-sponsored credit and so on?

Mr. **Olmer**. Well, Congressman McKinney, the ocean is so large and my boat is so small—the GATT system has got a lot of problems and there are many, many things that need to be done, but I wouldn't want to see it thrown out. I think that we require—I know that we require a structure that, however flawed, represents a hope of order and understanding as to what represents fairness, relative equivalents, and lays out a set of rules.

You are absolutely correct, the GATT system doesn't cover much of modern day trade and if we were to accept the system as it is today and look ten years ahead, it would even be more archaic. But that doesn't mean we should throw it out. Ambassador Brock, before he left, spent many, many hours with his staff determining the kind of program that needs to be put in place, negotiating with our trading partners all over the world to encourage their support for basic change. Whether we will get it remains to be seen.

We have one or two problems before we get there, but I think we have to keep fighting to try to get it.

Mr. McKINNEY. It seems to me that we really must do something because it's almost incomprehensible for me to try and evaluate what Government sponsorship of the loan of two A-300's to Frank Borman of Eastern Airlines free for 6 months means, or the fact that it's British Government social policy really the steel industry and the Rolls Royce engine industry rather than the relationship of what it would cost a Pratt & Whitney or General Electric to build a jet engine for commercial use, and I think the Japanese are experts in those things.

I was the coauthor with Mr. LaFalce's chairman before him, Bill Moorhead, of the Chrysler loan guarantee bill. I was fascinated that in this country we were worried about everything from antitrust to Government bailouts to everything else, and in the meantime Mazda was crashing with a resounding smashing sound over in Japan and everyone got together within their little cartel and the Government said, "Let's let the banks take equity, let's do this and that and everything else," and the next thing we know, the GLC borrowed from everybody against every antitrust law we had and everything else for one of the best-selling cars in the world and Mazda is back on route, so to speak, with the careful calculation of the Japanese Government as to how to keep it going.

It seems to me that that type of governmental interference is also very difficult for the free world—the "free enterprise" structure to live with.

My time is up, but I appreciate your concerns, and I just wanted to bring out those things because I don't think, Mr. Chairman, that we can just easily sit back and say we're looking for fairness unless we look through the entire banking system structure and everything else that's used in foreign trade.

Chairman LAFALCE. There's no question about that, Mr. McKinney.

Ladies and gentlemen of the subcommittee, Mr. Olmer has some time constraints, and we have four additional witnesses. So I would ask you, should you wish to ask questions, to limit yourself to 5 minutes and if you wish to forego questioning of Mr. Olmer that would enable us to hear from the other four witnesses. I will leave it up to your discretion, though.

Ms. Kaptur.

Ms. KAPTUR. Thank you, Mr. Chairman.

Mr. Secretary, I also want to wish you well after June 1 and say we will miss you very much. I'm anxious to see who your successor will be and I want to thank you and your wonderful staff for being very cooperative when we have sought information and tried to inform ourselves on the issues that you deal with on a daily basis.

I wanted to ask you a question. In your testimony this morning I guess I'm surprised at how well you thought the telecommunications negotiations went and I've read some reports in some of the trade journals that others may not share that opinion. I just wanted to register that.

But you feel that you achieved the objectives that you set out to accomplish, and you think the market over the next 5 years will look very different for American manufacturers, I take it, based on those negotiations?

Chairman **LaFalce**. For phase one.

Ms. **Kaptur**. Phase one.

Mr. **Olmer**. We had very ambitious negotiating objectives with respect to roughly one-third of our issues in the telecommunications sector, and we achieved virtually every single one of those objectives.

Whether or not achievement of that one-third will result in substantially increased sales of American goods over the next year or 5 years is a wholly separate question for which I think the chairman would not give me sufficient time to answer, Ms. Kaptur, in addition to which, I will be here for a while after June 1.

Ms. **Kaptur**. Great. That will give you time to answer my next question.

What troubles me about your testimony this morning in the sectoral discussion section, looking at the trade imbalance figures specifically relating to automobiles and steel, I'm a bit disappointed that more wasn't said in that regard and I wanted to share a story with you here.

One of the companies in my district, Champion Spark Plugs, for years has tried to do business in Japan and back in 1974 during some negotiations literally offered the company's product free to Japanese manufacturers, and for a decade has tried to get some kind of presence in that market with no success.

I'm wondering, what is being done in this automobile area? We know the President lifted the voluntary automobile restaints on April 1. In automobiles and steel, what initiatives are we taking in order to achieve any kind of penetration as you've talked about in wood products, telecommunications, electronics, and medical equipment? What's happening in these other areas where our trade imbalance is so much greater?

Mr. **Olmer**. We do not follow the policy of sectoral reciprocity. That is, we don't maintain that the Japanese surplus of perhaps $15 billion in automobile products ought to be offset by $15 billion of U.S. automotive products or in steel.

In the instance of steel, the Japanese have been forthcoming in negotiating with the U.S. Trade Representative's office a quota limitation on their exports to the United States in consonance with the President's program to aid the U.S. steel industry.

In terms of automotive parts, we have for several years had an effort in the Commerce Department to promote purchases by Japanese automotive manufacturers of U.S. parts. We have not been successful and I cannot excuse that failure as inadequacies on our part, but rather, unwillingness on the Japanese Government's part.

Ms. **Kaptur**. What can we do to help? What could we, in the Congress, do to help?

Mr. **Olmer**. Well, I think we have been witnessing that for the last few months, and I believe it ought to continue.

Ms. **Kaptur**. Well, it hasn't helped the auto parts companies in my district. I look at the figures over the last couple years for spark plugs where we have received an additional 36 percent inflow into this country. I look at Briggs & Stratton engines, which are not manufactured in my district, but small gasoline engines, and I see a 96-percent increase in value, and in automobile glass, a 40-percent increase.

These are very serious problems for companies in districts like mine and a number of us are going to Japan in July, and I ask myself what in the world could a group of Members on a bipartisan basis do in these troubled areas of automobiles, automobile parts and some steel products while we're there in order to be helpful. You know, no one seems to have been helpful for a decade.

Mr. **Olmer**. That's the best invitation I've had all day. I would be happy to provide you with an agenda, or a proposed agenda.

Ms. **Kaptur**. Oh, great. We would love it. We would welcome that.

But you're saying that in autos and steel we're just—especially in autos, we're just——

Mr. **Olmer**. I think that you're correct, there are automotive parts the Japanese should buy more of from the United States. I've believed that for 4 years and I continue to believe it.

I do not believe that other than perhaps in some specialty steel areas that would not have an enormous consequence to our overall trade deficit, however much it might help an individual company. I don't believe in steel at large that we are competitive with the Japanese. I just don't believe it.

Ms. **Kaptur**. Thank you, Mr. Secretary.

Chairman **LaFalce**. Thank you. Your time has expired.

Mr. Olmer, you suggested perhaps there was some question or issue you wanted to address and you were not given time to address it? I thought I heard you say that to Ms. Kaptur.

Mr. **Olmer**. I think that the issue of whether a given industrial sector or products from within a given industrial sector are competitive is a very complicated one and we shouldn't rise to quick judgment that the reason those imbalances exist is because of Government intervention.

In some cases, it's just flat out lack of competitiveness for a variety of reasons that relate to inadequate investment in capital goods, high labor costs, environmental protection regulations in this country which have inhibited capital investment, and a number of other things that I haven't talked about.

In some areas where we are, we need to insist on the rights of our companies to a fair shake, and that's the kind of thing that I'd like to do on a product-by-product basis with you and encourage that when you are there you assert those rights to the right people.

Ms. **Kaptur**. Thank you.

Chairman LaFalce. Thank you.

Mr. Bereuter.

Mr. Bereuter. Thank you, Mr. Chairman.

Mr. Olmer, I want to thank you for your fine public service.

Mr. Olmer. Thank you.

Mr. Bereuter. You have testified in the Foreign Affairs Committee and subcommittees that I'm a member of, and I'm not triplets; I'm just the same person moving around trying to help you with trade matters.

I appreciate the fact that you are concentrating on telecommunications, forest products, medical equipment, and electronics where we should be doing a lot better and where we do face trade barriers of one kind or another.

These sessions sometimes turn into self-flagellation because we concentrate on the things that we are doing wrong or which are counterproductive. But I want to talk about Japanese barriers and I'm going to use my time simply to give you my views because I think what the Congress says is important in contributing to the executive branch's progress with the Japanese.

Now I have a beef with the Japanese. In fact, I've got lots of beef for the Japanese. And I want to suggest that that's an area where we are quite competitive and these arguments about Japan taking a high percentage of our red meat exports are simply inappropriate arguments since we have such high value products that we can deliver very little else to anyplace else but Japan. But trade shows do show we have a market there. With cuts going for $20 to $30 a pound and with trade shows showing a huge demand, we have that potential there.

And I gather you don't mention that simply because we are in the midst of a negotiated period of time.

I'd like to put two serious proposals before you—I offer them in seriousness—and before the public. That is, one, now is the time to reopen those quotas the Japanese impose on red meat because of the outrageous things that Japan has done lately, and the worst of them is the kind of barriers they put up to our telephone and telecommunications firms.

Second, in contrast to everybody else talking about reducing surcharges, I want to volunteer that American meat producers are willing to have a 5-, 10-, 15-, 20-, 25-percent import surcharge imposed upon red meat coming into Japan to subsidize the existing meat producers in Japan and we will still be very, very competitive and, in turn, we expect to have the quotas eliminated totally.

The Japanese consumer would be better off; our producers will be better off, and their great concern about protecting their meat producers can be satisfied by a surcharge on our meat.

Let me also mention that I have, as an example, two manufacturers of disposable medical supplies in my district. They are very competitive. That's perhaps surprising in the kind of labor-intensive nature of that industry. But they face continual problems with labeling and packaging. And if they meet the Japanese standards, the Japanese standards remarkably change rather quickly.

So we continue to face those kind of nontariff barriers in an area where we are competitive. What they do on processed forest products is simply outrageous, and I'm simply amazed that they would propose the kind of things they have proposed, to take a look at our telecommunications products when they demonopolized the telephone industry in Japan.

I think your approach of not even going from San Francisco to Japan was absolutely correct. It was an outrageous thing to suggest to an ally that we accept that kind of treatment.

We have a lot of progress to be made and I want to simply encourage you to try to get the Japanese at the Bonn Summit to ask them to discontinue the artificial maneuvering and manipulation of the yen. It's hard to prove, but it's clearly apparent and it's been happening for years and years. I would hope that all of the countries represented at the Bonn Summit would emphasize the $44 billion trade surplus that Japan has with the world, $37 billion of which is with us.

Is there any kind of action that we might get from the administration—and my only question to you—on trying to eliminate antitrust barriers in this country through joint research and development projects and in joint marketing in Japanese markets—anything we can expect in the way of leadership from the administration in that area?

Mr. **Olmer**. You know of Secretary Baldrige's commitment to that very theme, and he will continue to pursue it. We've had some success in the removal of antitrust barriers in research and development. He believes a great deal more needs to be done, and I know he will continue to push it.

Mr. **Bereuter**. Why does he face the difficulties he does in the administration and from what sources? As an outgoing representative, he might be able to speak candidly on that subject.

Mr. **Olmer**. It's no big secret. I mean, his experience is that of an industrialist and as a promoter of U.S. exports of goods and services. Those that have written our antitrust laws are not industrialists, who view competition from a different light. And some of their lights have gone dim over the years, in the view of those of an industrial background.

There's an appropriate adversarial nature to at least some of the process. I think it is appropriate. I do think that time is running out and action does need to be taken, and of course, I support the views of my boss in that respect. I might point out that there are some barriers that might be lifted. I wish Mr. McKinney were here. He is author of an amendment to the 1979 Export Administration Act that prevents the export of Alaskan crude oil even on a spot basis. That could provide several hundreds of millions of dollars and a lot of jobs in Alaska, if it were permitted.

Mr. **Bereuter**. Thank you very much, Mr. Chairman. My time is up.

Chairman **LaFalce**. Thank you very much. Mr. Kanjorski.

Mr. **Kanjorski**. Mr. Chairman, I'd like to take this opportunity to relate my views on our imbalance of trade with Japan and also on our trade relations with the Japanese.

The current $40 billion trade imbalance with Japan is the result of a number of factors. First, the U.S. trade and tariff restrictions on imports are the least prohibitive of all the industrial nations in the world. Our open markets allow other countries virtually unlimited access to our economy, which, as we all know, is the world's largest consumer-product-oriented and with a great deal of disposable income.

Second, our Nation is truly a melting pot of people. It is not as homogeneous as that of other nations. We do not have the hesitancy or prejudice against foreign-made products that exists in many other countries, particularly concerning American-made goods.

Third, the overvaluation of the dollar which, when compared to other currencies has made American products more expensive and foreign goods less expensive.

Last, our products do not enjoy the reciprocal access to foreign markets that their goods enjoy here. If we are to significantly impact our $40 billion trade imbalance with Japan and the $120 billion imbalance with the world, we will have to address each of the areas I have outlined.

There is no doubt the Japanese need to open their markets. Current restrictions on telecommunications, pharmaceuticals, agriculture, lumber, coal and other products must be lifted. We must focus our attention on fair trade and not just an abstract theory of free trade.

The rising protectionist talk here in Congress is not partisan rhetoric, but is the result of an outcry heard from the people we represent who have and will lose their jobs as a result of current imbalances. My district has already lost over 1,000 jobs in the textile and apparel industries, and within the next 5 years will lose 10,000 more, These people are honest, hardworking citizens who believe in the American dream and the ideals of freedom and democracy. It is my job to represent and protect their interests.

One area of possible reconciliation is that the Japanese investment in the United States which helps maintain and produce American jobs, Japan's direct investment in the United States since 1980, has more than doubled to $11.1 billion in 1983. The increase from 1982 to 1983, $2.2 billion, while representing a 23-percent increase, is only 7 percent of the current trade imbalance.

I would strongly suggest to Japan that one good faith effort, in addition to opening their markets, would be to reinvest a greater portion of the trade imbalance into the United States to create jobs, products, and profits here in this country. I feel this would be a wise and prudent course of action.

Mr. Olmer, I welcome you before the committee, and I only want to ask you one question.

What is your impression of the Japanese intentions of exporting their capital into the American market to provide for jobs that are lost here in this market?

Mr. **Olmer.** I don't think that they directly link it to the creation of jobs which might be lost because of diminished American industrial competitiveness, but they clearly have an abundance of capital looking for a safe and profitable haven, and there is no better place for their investment than the United States, given our free investment climate. You properly point out the doubling of Japanese investment capital in this country since 1980, and I feel confident that it is going to continue to increase.

Mr. **Kanjorski.** Is there anything we can do here in the Congress besides the expression of our dislike for the present attitudes as to our imports to Japan, to encourage the flow of capital into this country to alleviate the problem of our unemployment?

Mr. **Olmer**. I believe it is a widespread view that America has the most open investment climate of any nation on Earth, of any size. And the Japanese are well aware of that. There are a few things that trouble them, such as unitary tax, and I believe that it is up to the jurisdictions that want Japanese investment to rectify that disincentive toward investment, and a number of them already have.

Chairman **LaFalce**. The time of the gentleman is expired. Mr. McCandless.

Mr. **McCandless**. Thank you, Mr. Chairman. Three quick questions, hopefully.

The first one is, we're reliving history this week. Is the fact that we had a previous adversary role with the Japanese anything to do with the difficulty that we experience?

Mr. **Olmer**. I don't believe so, Congressman. I believe that Japan has to be counted as one of America's staunchest friends, both in trade, political, and diplomatic terms.

Mr. **McCandless**. The second question I have is, in view of Nissan of North America or whatever they call themselves and the various other manufacturing corporations that have been set up here in the United States, there seems to be great difficulty beyond that of even some of the others we've talked about of trying to do the same thing in Japan, coownership of manufacturing and production facilities.

Do you see any light at the end of the tunnel in that area?

Mr. **Olmer**. The Japanese have selectively taken steps to make it easier for American or non-Japanese companies to invest in Japan. It is not yet anywhere near the equivalent of the United States, as representing an open opportunity for investment, and we've been working with them on that.

I believe that at a political level, there is an agreement that it is desirable to loosen up a little bit. I don't yet accept the notion that they're perfectly prepared to adopt the mirror image of the United States, but there is certainly room. If you look at some of the American high technology companies, you find that they've been beating a path for investment opportunities in Japan, and many of them have already established manufacturing operations there, in addition to marketing and service activities. The problem is that oftentimes they feel that they're not being given a fair shake and that the cost of their investment there sometimes embraces the need to part with technology they'd rather not part with or some other performance requirement that we think shouldn't be part of the calculation.

As a Government, we're working on that with the Japanese Government, and we've had, I'd say, a pretty fair degree of success with the Japanese Government.

Mr. **McCandless**. And finally, in the Third World countries, where capital is so badly needed to develop the infrastructure to improve the economy, standard of living and everything, the Japanese have a surplus of capital. They do participate in many of the multinational organizations, but it would appear to me that it would also not only be in our interest but in their interest to promote the development of some way by which the Japanese could expand their involvement, as far as capital placement is concerned in these Third World countries, which, if for no other reason, would be to ultimately provide additional markets for their products.

Does that ever come up for discussion in your area of jurisdiction—operation?

Mr. OLMER. Not directly in my area of responsibility, but I have been part of the effort to encourage the Japanese to do just that. If we were to look at Brazil, for one example, two-thirds to three-quarters of Brazil's increase in exports have come to the United States. Precious little has found its way to Japan or even the European Community. I think that we could get a lot more cooperation out of the Japanese, both in terms of accepting exports from the developing world, those countries that are either desperately poor or are undergoing structural adjustment in a most fiercesome way, and in addition, that the Japanese Government could encourage their companies to invest in those countries more than they have, absolutely.

Mr. MCCANDLESS. Thank you, and I'd like to add to those remarks of my colleagues, my feeling about your public service. It's very much appreciated.

Mr. OLMER. I thank you, sir.

Chairman LAFALCE. Thank you. Mr. Levin.

Mr. LEVIN. Mr. Chairman, I'm sorry I've had to miss so much of this, and I don't have any questions. I'll catch up in other ways.

I just have a brief comment. I think that there have been varying perceptions about the impact of the present structure on American business and commerce. Those differing perceptions had much to do with the level of concern about Japanese trade practices, and I think we're going to have to realize that. Basically, there was a lower level of concern about the impact of Japanese and other trade practices in the United States because there were differing feelings about how serious that impact was. And those of us from States which were very seriously impacted, were some of the earlier ones to cry foul. The perception is broadly held in the area that I come from that the Executive was considerably behind the Congress in being concerned about the end product of Japan and other trade practices.

I think there's been some change in recent weeks and perhaps in the last month and a half in this, Mr. Chairman, but for the people that I've heard in the district and throughout Michigan and in other States, I think what they're saying is that the proof will be not in the rhetorical negotiations but in the reality of practices. Your job, as arduous as it is, Mr. Olmer, will not have been done effectively in the eyes of constituents of mine anyway, until they see some differences in actual practice and a change in the imbalance.

Chairman LAFALCE. Thank you, Mr. Levin. Mr. McMillan.

Mr. MCMILLAN. Thank you, Mr. Chairman. I will obviously have to be very brief. I would like to express my thanks to you, Mr. Olmer. I've met with you on two occasions since becoming a Member of Congress, and I've been very impressed with your knowledge and your dedication, and I'm sad to see you leave your present position.

Mr. OLMER. Thank you, sir.

Mr. McMILLAN. I can say many things about my concerns about our trade policy over time. I come from North Carolina, perhaps the center of the textile industry, and we have perhaps lost close to a quarter of a million jobs in this country since 1980, as a result of imports into this country. Probably in that period of time, not primarily from Japan, but I think as the result of many of the same weaknesses in our trade policy.

Congressman McKinney alluded to it and you alluded to the very complex issue of various forms of government intervention in the businesses of their own countries, call it subsidy, call it variance in regulation, and so forth. And I think that has perhaps received the least attention in the discussion today, it is complex, but real quickly, I would be interested in your comments on the degree to which you think the imbalance, our current imbalance with the Japanese results from differentials in governmental policy or subsidy, as opposed to just pure lack of competitiveness, and then very briefly, to outline the potential remedies of dealing with that in our trade negotiations.

Mr. OLMER. I believe that we probably have more than half of our trade deficit caught up in the imbalance in the relationship between the yen and the dollar, and that perhaps as much as 25 percent of our deficit with Japan could be eliminated, if all barriers to trade were dismantled.

You've asked for somewhat of a subset of that, that is, of Japanese Government subsidies and certain other kinds of Japanese Government intervention. I do not believe that currently the Japanese Government expends on private sector companies a lot of money on direct subsidies. I believe that at one time they did in areas which ultimately grew up to haunt us in the so-called infant industries concept of the late 1960's and early 1970's. But as a matter of government practice, they do not currently, to the best of my belief, engage in the kind of massive subsidization that we see, for example, in a number of steel industries around the world.

Nonetheless, government intervention, government policies have an effect. They have an effect in the financial world, as Mr. McKinney pointed out. They have an effect in encouraging the kind of close relationship between and among Japanese industrial groups from a bank, through an export house. Some of that is not per se illegal, although it does reduce the chances of an American company making a sale.

I think we have the kind of political commitment that recognizes that okay, even if it isn't illegal per se under international rules, the size of our trade account with the United States has reached political proportions and more needs to be done to encourage the Japanese to buy foreign products. They have operated for many years with the strategy of export or die. A country that is largely bereft of natural resources, it was natural that they encourage that kind of philosophy. That situation hasn't changed, but their success has so overwhelmed other elements of the relationship that they have with many countries in the world, not just the United States, that I do believe that we are seeing the beginning of an effort to encourage a different strategy, a strategy that is premised on the notion that in order to export sufficiently to maintain the Japanese economy, the Japanese Government and its business community must encourage imports as well.

Mr. **McMillan**. Thank you, Mr. Chairman.

Chairman **LaFalce**. Thank you very much, Mr. Olmer.

This is probably the last time you will appear before our subcommittee, at least as a governmental official. I regret that very, very much, but, as usual, your testimony has been outstanding and your insights very informative for this subcommittee.

The subcommittee will recess until 12:30, when we will reconvene to hear an outstanding panel. I encourage every member of the subcommittee to return. We have spokesmen for the Electronic Industries Association, the Semiconductor Industries Association, American Express and academia.

Thank you.

[Recess.]

Chairman **LaFalce**. The Subcommittee on Economic Stabilization will reconvene.

I'd ask the four panelists to take the table.

We're going to go slightly out of order. I understand that Mr. Freeman has a time constraint so, although we will hold off questioning until all four of you have concluded your remarks, we will ask Mr. Freeman to testify first, followed by Mr. McDonnell, and Mr. Calder.

Mr. Myrick has arrived so he will be testifying for the Semiconductor Industries Association.

Gentlemen, we will put the entire text of your remarks in the record, and I ask you to summarize your remarks in no more than 10 minutes and if you can do it in 5 minutes, that would be even better.

Mr. Freeman.

STATEMENT OF HARRY L. FREEMAN, EXECUTIVE VICE PRESIDENT, THE AMERICAN EXPRESS CO., NEW YORK, NY

Mr. **Freeman**. Thank you very much, Mr. Chairman. It's my pleasure to be here.

I'd like to focus my remarks today on what we think is one crucial aspect of bilateral services trade—financial services. In particular I want to discuss the ways in which the liberalization and internationalization of the financial service markets, particularly in Japan, could help the United States and, for that matter, the rest of the world, deal with its very rapidly developing international debt.

Sometime in the first quarter of this year, the United States became a net debtor country for the first time since World War I. We're all aware of the factors that have contributed to this: the strong dollar, the fiscal deficit, and as a consequence of this, a current account deficit of over $100 million, the biggest part of it with Japan.

The result of this has been a $100 billion balance of payments shortfall that must be financed either by borrowing, by exporting much, much more or by importing much, much less or some combination of these.

The most likely cost is a continued trade deficit that must be financed by borrowing from abroad, with much of that being recycled from the proceeds of the Japanese export boom.

Moreover, under any set of assumptions about the future rate of growth of the U.S. economy and the strength of the dollar it is virtually inevitable, we think, that the U.S. current account deficit will stay big for at least a number of years. As a result, it is assured that there will be continued substantial buildup of our net foreign liabilities that will also persist for several years.

I've attached to my testimony a graph which demonstrates that condition. I'm sad to say that under any scenario we have, we're talking about a debt range of $300 billion to $900 billion over a time frame of 3 to 4 years—1988, 1989. We're talking about a huge development which has received very little attention.

There are a number of variables. According to our economists, if we have a continued strong dollar we'll see a net debtor position between $500 and $700 billion by 1988. That depends, again, on the strength of the U.S. economy.

Even under an optimistic condition for balance of payments—and I put optimistic in big quotes—optimistic means a very painful recession starting almost immediately—we would still have something like a current account deficit building up to a net liabilities abroad of around $300 billion. I would not call having a recession an optimistic scenario.

The adverse trade balance in the United States and Japan is an appropriate concern for both governments and the private sector in both the United States and Japan. However, to my knowledge, little has been said about the emerging super debtor status of the United States and the super creditor status of Japan. This issue could be as important over time as the merchandise trade issue which was discussed this morning.

The other side of the coin of the United States becoming a very large external debtor is that Japan will quickly become an enormous creditor country, perhaps up to $500 billion in the next couple of years. That's the mirror image of the U.S. debtor position.

Since it seems virtually inevitable that our reliance on foreign funds will continue to grow rapidly over the next few years, the challenge then is to fashion an international regime that encourages continued foreign capital flows into the United States but minimizes the volatility and uncertainties associated with those flows and also does not divert needed resources from the developing world.

An essential feature of this kind of regime is a very well-oiled international financial system that efficiently recycles the proceeds of our current account deficit in other countries into lending back to the United States.

First and foremost, this requires the development of an efficient Japanese financial institutional structure and the internationalization of Japanese capital markets to the extent they haven't been already.

As the United States has quickly become the world's largest debtor, Japan will rapidly become the world's largest creditor.

It's an anomaly, however, that despite Japan's position as a world industrial and trading power, Japanese financial institutions and markets until quite recently have been heavily regulated and somewhat insular.

This has been reflected in the highly limited use of the yen in international transactions and borrowing, and in the lack of full participation by foreign financial services firms in Japanese capital markets.

We are now seeing, however, a major transformation of the Japanese financial system. The Japanese are breaking down many regulatory barriers, injecting competition, developing a much more sophisticated consumer, and internationalizing what had once been a highly controlled capital market generally off limits to the outside world. My testimony lists some of the movements in this area.

One of the most significant developments in the internationalization and liberalization of the Japanese financial system is the Tokyo offshore banking facility that is now in the planning stages.

Such an offshore facility in Tokyo will have major benefits for both Japanese and American companies alike, and will be one more important step toward increasing Japan's capacity for contributing to the international financial system. We commend the Japanese Ministry of Finance for this initiative and encourage them to launch the facility sooner rather than later.

All this adds up to substantial progress in Japan but we need more. This progress could mean a great deal as we explore new ways of accommodating the United States as a major debtor and Japan as a major creditor.

Indeed, Mr. Chairman, with the amounts we're talking about, debtor and creditor sometimes develop partnerships as we have seen over the years, with the United States being a creditor to many developing countries.

The amounts get so large that I think, for all practical purposes, we will have to cooperate and the Japanese will have to cooperate in order to manage this situation as it develops this year, next year, and over the next 2 or 3 years.

In closing I would say that we must realize that the United States and Japanese financial markets are closely related now and will become more interactive in the future.

The world is truly becoming one electronic village and global trading of all kinds, global financial markets of all kinds, and global financial interdependence are already very much with us. In that sense, whatever we suggest to Japan is also a suggestion to ourselves because we're all in it together.

Thank you, very much.

[Mr. Freeman's prepared statement on behalf of the American Express Co. follows:]

TESTIMONY

OF

Harry L. Freeman
Executive Vice President
American Express Company

Before the

U.S. House of Representatives
Subcommittee on Economic Stabilization
of the
Committee on Banking, Finance and Urban Affairs

April 30, 1985
Washington, D.C.

AMERICAN
EXPRESS

Mr. Chairman, distinguished members, my name is Harry Freeman and I am Executive Vice President of American Express Company. I am very pleased to be here today to discuss a service industry view of U.S. - Japanese trade relations.

Rather than address the broad range of bilateral services trade issues, however, I would like to focus my remarks today on one crucial aspect of bilateral services trade -- financial services. In particular I want to discuss the ways in which the liberalization and internationalization of financial service markets, especially in Japan, could help the United States deal with its rapidly developing massive international debt.

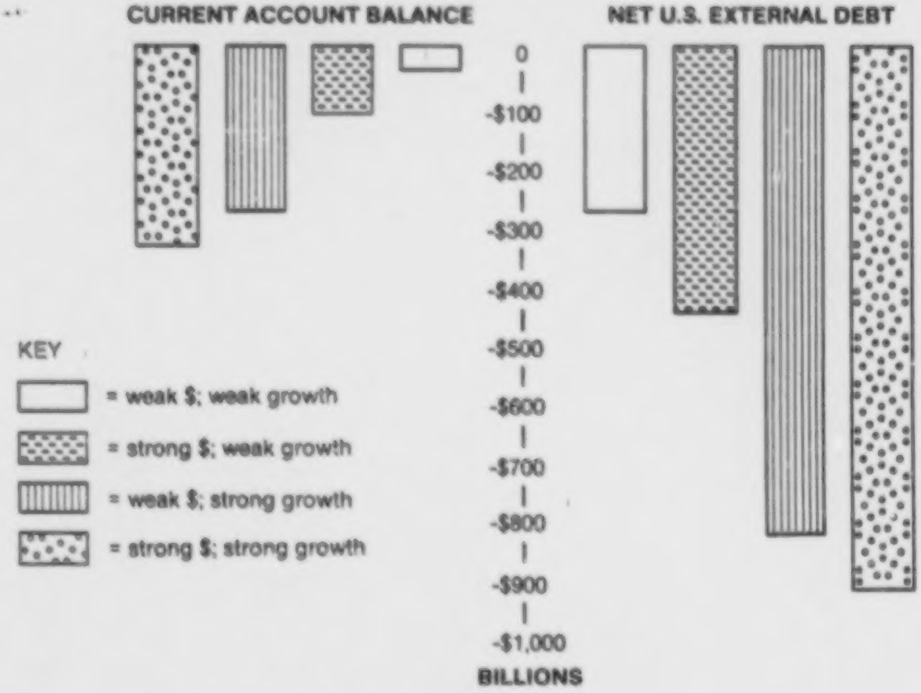
Sometime in the first quarter of this year the United States became a net debtor country for the first time in 65 years. We are all aware of the factors that have contributed to this event: strong U.S. growth that has outpaced expansion overseas, a massive U.S. fiscal deficit, the persistently strong dollar, and, as a consequence of all of this, a current account deficit of $100 million, the biggest part of it with Japan.

The result has been a $100 billion-plus balance of payments shortfall that must be financed by (1) borrowing, (2) exporting much, much more, or (3) importing much, much less. The most likely cost is a continued trade deficit which must be financed by borrowing from abroad, with much of that being recycled from the proceeds of the Japanese export boom.

Moreover, under any set of assumptions about the future rate of growth of the U.S. economy and the strength of the dollar, it is virtually inevitable that the U.S. current account deficit will stay big for at least several years. As a result, it is assured that there will be continued substantial build-up of our net foreign liabilities that will also persist for several years.

I present a graph which demonstrates this condition.

POSSIBLE TRENDS IN U.S. DEBT ACCUMULATION
(IN BILLIONS)



There are a number of variables here, but all scenarios point to this growing debt:

- According to our economists, with a strong dollar we will see a net debtor position of between $500 and $700 billion by 1988, depending on the strength of the U.S. economy.

- Even under the most "optimistic" conditions -- a very weak dollar combined with a long painful recession -- a current account deficit of $300 billion is still likely.

And there is not very much we can do on the trade front to change this in the near term, even if we were to wage an all-out attack on the biggest beneficiary of the U.S. current account deficit -- Japan. If tomorrow, Japan decided to do away with all of its barriers to U.S. products, our export performance would only be likely to improve by around $10 billion -- only part of the current $37 billion deficit with Japan and a mere drop in the bucket when we start talking about $300 billion world trade deficits.

The adverse trade balance in the U.S. and Japan is an appropriate concern for both governments and the private sector in both countries, and I expect other witnesses today will address that dilemma directly. However, to my knowledge little has been said, or done, about another large subject which is developing between the U.S. and Japan, namely the emerging superdebtor status of the U.S. and the supercreditor status of Japan. Consequently, my statement should not be interpreted as ignoring the trade deficit question as I attempt to deal with another, but related, question which could be as important over time as the merchandise trade issue. The other side of the coin of the U.S. becoming a very large external debtor is that Japan will quickly become an enormous creditor country -- perhaps up to $500 billion in the next few years.

The American economy is, of course, huge and has enormous capacity to service debt. And the massive inflow of capital has contributed to the flourishing U.S. economy by helping to finance our budget deficit and by keeping domestic inflation and interest rates down.

However, there are some valid concerns that this rapid and massive increase in U.S. reliance on external borrowing could destabilize the world financial system and could make the U.S. more vulnerable to the whims of foreign financial markets.

Foreign investors have been attracted to the U.S. because it is a safe haven with good prospects for growth and high rates of return. But foreign funds may be less stable than domestic funds, more subject to rapid and massive flight. There are also fears that such heavy reliance on foreign funds could impose serious constraints on U.S. monetary policy.

In an article this month, the New York Times reported that some of these foreign funds already shift rapidly within U.S. markets. The Times reported "Much of the $35 billion foreigners put into Treasury and corporate issues last year was moved out of domestic certificates of deposit (CD's) due to fears about the stability of the banking system...now we see them moving back to CD's."

Since it seems inevitable that our reliance on foreign funds will continue to grow rapidly over the next few years, the challenge is to fashion an international regime that encourages continued foreign capital flows into the U.S. but minimizes the volatility and uncertainties associated with those flows and also does not divert needed resources from the developing world. An essential feature of this regime is a well-oiled international financial system that efficiently recycles the proceeds of our current account deficit in other countries into lending back to the U.S. The potential for volatility in the financial markets in this scenario is tremendous - much more so than in our current environment which many observers think is quite volatile indeed. The challenge, then, is more recycling of funds than a trade problem.

I would also like to make it clear that the external debt question is very closely related to U.S. fiscal policy and very closely related to the action which the Congress takes on the deficit. That, however, is a subject worthy of another paper. Suffice to state here that lack of progress on the deficit question can only exacerbate the debt question.

First and foremost, this requires the development of an efficient Japanese financial institutional structure, and the internationalization of Japanese capital markets. As the U.S. has quickly become the world's largest debtor, Japan, largely by virtue of its tremendous export performance, is rapidly becoming the world's largest creditor. Our economists estimate that Japan's external creditor position $500 billion within a few years.

However, it is an anomaly that, despite Japan's position as a world industrial and trading power, Japanese financial institutions and markets until quite recently have been heavily regulated and somewhat insular. This has been reflected in the highly limited use of the yen in international transactions and borrowing and in the lack of full participation by foreign financial services firms in Japanese capital markets.

I am pleased to report that all of this is changing dramatically. In fact a major transformation of the Japanese financial system is currently under way, breaking down regulatory barriers, injecting competition, and rapidly internationalizing what had once been a highly controlled capital market, generally off limits to the outside world.

Some of this has been the result of outside influence -- notably the so-called Yen-Dollar Agreement of 1984 which permitted the growth and development of the Euroyen bond market and helped to foster a market for Euroyen lending. Much of the impetus for change, though, is coming from within the Japanese financial markets from companies and industries that are eager to compete for the huge international financial markets that are emerging, largely as a result of the demands imposed by the growing U.S. international debt.

And all of this is moving along -- the Japanese are moving in some respects with more alacrity to deal with the insularity of their financial system than the U.S. Government is in dealing with its deficit. Keep in mind that it was only five years ago that Japan first did away with foreign exchange controls, thus setting the internationalization and deregulation process in motion.

Since then the Japanese have made major strides:

- Restrictions have been eased for foreign companies that want to raise yen funds in Japan, either through the public "samurai" bond market or through direct private placements.

- The Euroyen market has been expanded by permitting non-Japanese corporations to tap pools of yen funds held offshore.

- The withholding tax on non-Japanese holders of Euroyen bonds is being eliminated, removing a major obstacle to the issuance of Euroyen bonds by Japanese companies.

- Foreign banks will be allowed to enter the trust banking business, which has heretofore been closed.

- In domestic market, Tokyo has removed interest rate ceilings on large deposits and has built up a free trading market for government securities.

- Standards for companies issuing unsecured bonds have been relaxed.

Finally, one of the most significant developments in the internationalization and liberalization of the Japanese financial system is the Tokyo offshore banking facility that is now in the planning stages. Such an offshore facility will have major benefits for Japanese and U.S. companies alike and will be one more important step toward increasing Japan's capacity for contributing to the international financial system. We commend the Japanese Ministry of Finance for taking this bold and positive step towards the liberalization of Japan's financial services markets, and we hope that the facility is launched sooner rather than later.

The facility would enable Japanese and foreign banks to participate in the offshore yen market without establishing costly and less efficient branches in London. It will help make Tokyo the Asian leg of the international financial triad that will permit worldwide 24-hour trading in securities. And it will create new efficiencies and earning opportunities for the Japanese financial institutions and foreign financial institutions alike.

If it is properly constructed, it could also pave the way for more liberalization of the Japanese domestic financial services industry and greater involvement of foreign firms in that industry.

So all of this adds up to substantial progress in Japan that could be mean a great deal as we explore new ways of accommodating the U.S. debt.

Of course there is still a lot to be done. For example, complete interest rate deregulation in Japan should be a major goal. There are currently no foreign companies seated on the Tokyo stock exchange and there is a dearth of foreign companies listed there. And there a the need for considerably more yen-based trade financing.

In encouraging and supporting these developments in Japan, we should keep in mind that the Japanese have a very justifiable concern that overly hasty renovation of their financial institutions could threaten the fundamental soundness of Japan's financial system, which has until recently been finely tuned, carefully balanced and highly protected. There are trade-offs to be made within the Japanese government and the Japanese financial industry and careful balances that will have to be considered. This could take some time. Witness the ongoing process of financial industry deregulation in the U.S., which itself has often involved major restructuring and shakeout in the industry.

We must realize that the U.S. and Japanese financial markets are closely related and will become more interactive as the months and years go by. The world is truly becoming one electronic village and global trading, global financial markets and global financial interdependence are already very much with us. In that sense whatever we suggest to Japan is also a suggestion to ourselves.

Thank you, Mr. Chairman.

Chairman LaFalce. Thank you very much, Mr. Freeman.

Because I know you will be leaving to catch a plane, let me just ask you a few questions now, and I will want you to stick around until you need to leave.

The yen-dollar agreement of 1984 you made reference to hasn't been as successful as was hoped in correcting the yen-dollar imbalance. What, in your view, accounts for that failure?

Mr. Freeman. I think it's just the inertia of the system. I think we see a lot of inertia built into the Japanese system. Many of the things that Mr. Olmer said this morning apply to the financial markets with the built-in interests not necessarily barring foreigners, but the Japanese groupings as they are.

But I think this is changing very rapidly and the Japanese are becoming concerned about their massive export of capital and how they manage that strategy in the sense that you would think now about how we, as a country, manage our becoming a net debtor to the world.

Chairman LaFalce. Do you have any idea of the foreign capital in the United States right now which is the major means of financing our present debt? Do you have any idea what portion of that has been from Japan for this past fiscal year?

Mr. Freeman. I can't recall the numbers; it's a very large amount, and, of course, this shifts—its ownership shifts.

Chairman LaFalce. When we say large, are we talking about 10 percent, 75 percent, roughly?

Mr. Freeman. I'm sorry. Maybe I misunderstood the question. The current account deficit must be financed from abroad by definition. So if our current account deficit is $100 billion, we will bring in, in that year, $100 billion of foreign capital, in one form or another. It may be 10-day or overnight rollovers or it may be permanent investment in equity in a plant.

Chairman LaFalce. Do you think that one of the reasons for the overvalued dollar above and beyond our budget deficit might be the fact that the exchange rate is dependent more upon capital flows than trades and goods?

Mr. **Freeman**. No, I don't agree with the theory that the large so-called capital flows itself changes the value of the dollar. I think those are results of the value of the dollar as it relates to the yen, the pound, the mark. I think the causes are the normal usual causes ascribed to the strong dollar, namely, the deficit and the other factors. I think the large capital flows, which are basically changing the ownership of one account to another in usually a large New York or Chicago or California bank, are a result but not the cause of the overvalued dollar.

Chairman **LaFalce**. What would be required to further liberalize Japan's financial markets?

Mr. **Freeman**. They're proceeding to deregulate interest rates to the consumer and to institutions. They've gone part of the way. The kind of thing we did in the United States a few years ago would go a long way.

I subscribe to what Lionel Olmer said earlier about building a constituency in Japan. That is happening at the institutional level of financial consumer and the individual level of financial consumer just as it has in the United States when we got away from—the formula 3–6–3 in the formal banking—you take the money at 3 percent on the passbook accounts, you loan it out at 6 percent and at 3 o'clock you hit the links. That was the old way. Well, that is no longer there.

This is starting to happen as Japan liberalizes and as the various borrowing——

Chairman **LaFalce**. What is the regulation they have now on the interest?

Mr. **Freeman**. Certain length of deposits. Various regulations put in by the Ministry of Finance, normally, will stipulate an interest rate for a certain term. Those are being removed, I would say, a couple of times a year there is a liberalization. The Japanese are moving, in fact, rather rapidly in that direction.

So that you now get to a position where consumers can get more of a market rate and the Japanese financial intermediaries, the securities houses, are doing what we did in the United States a few years ago to bring, say, money market rates to the consumer one way or another.

As this happens you build in a constituency, as we have in the United States, for even further deregulation. So that ball is starting to roll and it's gathering power.

Chairman **LaFalce**. Well, let me just understand it then. It's not simply that the United States is paying market interest rates which are higher than market rates abroad; it's that Japan is not paying market rates of interest in Japan.

Mr. **Freeman**. In many parts of the economy, that is true, but that is lessening and——

Chairman **LaFalce**. I understand it's lessening. Let me just ask you this. Although it's lessening, to what extent would you say that deposits in Japan are in artificially regulated funds, and to what extent would you say they are now in deregulated funds?

Mr. **Freeman**. I don't think I know the proportion. I could try to supply that for you but I——

Chairman **LaFalce**. Would you? I think that would be fascinating. I wasn't aware of that portion of the problem before this, to be quite honest with you.

[In response to the request of Chairman LaFalce, the following information was submitted for the record by Mr. Freeman:]

Most deposits in Japan are still regulated. In the last several months, particularly since the Yen/Dollar Accord, the Japanese have created deposit-like instruments for very large depositors. These instruments allow wealthy individual or institutional investors to get the benefits of market rates. One such instrument is a one-month CD for which the minimum denomination is 100 million yen. The other is a CD-like instrument called a money market certificate for which the maturity is three to six months and the minimum denomination is 50 million yen. These denominations have been changing, but fundamentally, most deposits are still regulated.

Mr. **Freeman**. But the point I'd like to make is that the irreversible movement is toward a freedom in the interest rate which is very much of a key toward the opening of Japan's capital market internally from traditional regulated channels and internationally. That, combined with the merging creditor position of Japan will push this very rapidly.

Chairman **LaFalce**. About 2 years ago didn't someone from American Express write an article about Japanese trade barriers, especially with respect to financial services, companies within the United States?

Mr. **Freeman**. It might have been I. I've spoken out on it or my colleagues have. I think many of those barriers still exist but my company has made progress. I mean, we're operating more in Japan now than we were a year ago. And we've applied for various kinds of permits or licenses. It takes a while, but we've been getting them.

So I'm not suggesting that we call up and we get what we want. We don't get that in the United States either.

But I am suggesting that Japan is moving in the direction of opening up its markets. One can argue over the speed but the direction is clear. I think much of it is by necessity, by what's going on outside of Japan. In other words, by the growing creditor position of Japan and also by the enlightened or the more educated Japanese consumer.

Chairman **LaFalce**. Thank you.

Mr. **Shumway**. Mr. Freeman, usually when we talk about the trade imbalance with Japan, we're referring to manufactured goods and I notice you represent a service industry, providing financial services.

Do you know to what extent the trade imbalance may be reflected by your kind of industry? In other words, I take it's a bilateral industry working in both directions. Has there been contribution to that overall trade deficit among the service industries or is it entirely manufacturing?

Mr. **Freeman**. I think its substantially all manufacturing. I am not sure there are statistics precisely on the bilateral service trade. The statistics in the service trade generally are inadequate. This is being looked at and attended to, but it will take a number of years before we have good information.

There's a very interesting article in Business Week that just came out about improving the census figures, the balance of payments figures, and the standard industrial code classifications for the service sector as directed by legislation that was passed by this Congress last year. It would take a number of years to accomplish this task.

I don't think anybody could really stand up and say with authority whether the exports of U.S. services, as distinguished from capital flows, have been positive or negative with Japan.

Certainly, the presence of large Japanese banks, particularly in California, has been very positive for the Japanese export of services. You also see the security houses, Neumora, Niko and others, around the United States.

On the other hand there are 50 foreign banks, a number of them American, and American securities houses in Japan. My own company, American Express, has a very active American Express card operation in Japan. That type of thing just doesn't even show up in the U.S. exports. So, I'm sorry I can't give you a solid answer on that.

Mr. **Shumway**. Much of Mr. Olmer's testimony—I guess in fact all of it—dealt with the kind of restrictions that Japan is imposing upon our manufactured goods, either tariffs or quotas or something of this sort, or these nontariff trade barriers.

You haven't necessarily encountered that as a service industry representative, I take it? Even though you haven't been able to call and get what you want, you still have applied and essentially found the door open to those kind of services that you wanted to market to Japan?

Mr. **Freeman**. In general, yes, and I think that the Congress' passage of the Trade and Tariff Act last October has been very helpful because it puts the service sector exports from the United States on the same footing as the exports of goods. Now, if we run up against a major trade barrier in Japan or elsewhere, we as a service sector company can file, if we must, a section 301 complaint.

Now, you rarely get to that stage, but the knowledge that you have the power to invoke the trade laws of the United States when before you did not, alters your bargaining position around the world.

I am not suggesting that my company is going to use that power in Japan or elsewhere, but it sure makes you feel a lot more comfortable when you assess foreign markets and decide to get into a foreign market, that you have the arsenal of trade weapons that other industries do in the United States.

Mr. **Shumway**. All right. I see no other Members present. Thank you, Mr. Freeman.

Mr. **Freeman**. Thank you very much for your special attention.

Mr. **Shumway**. This is a rare moment for a Republican Member of this subcommittee. Chairman LaFalce has had to step out for just a moment and asked me to continue the hearing in his absence.

We appreciate your testimony. Mr. McDonnell, we will call upon you next.

STATEMENT OF JOHN J. McDONNELL, JR., GROUP VICE PRESIDENT, INFORMATION AND TELECOMMUNICATIONS TECHNOLOGIES GROUP, ELECTRONIC INDUSTRIES ASSOCIATION

Mr. McDONNELL. Thank you.

I am delighted to have this opportunity to appear before this subcommittee and representing the views of our industry, especially since, without sounding chauvinistic, the telecommunications industry is the world's technological leader and has experienced dramatic growth here in the United States over the period, especially, from 1978 until the present, not just in terms of dollars but also in terms of the number of companies that have entered the industry.

Yet in spite of that fact, in 1983 the balance of trade on telecommunications equipment went negative for the first time in our history, and in 1984 that trend was accelerated and the balance of trade in telecommunications went to a negative $600 million. Of course, we find this appalling, since high technology has always been more or less the flagship of U.S. trade.

You have to ask yourself why this is true, if we truly are the world's technological leaders, and when you dig into it you find out that the reason it is true is that the world's telecommunications markets are closed. In fact, I was somewhat disturbed at some of the comments I heard this morning about the GATT and how well GATT is working because one of the major thrusts that we have had within the association is to try to bring telecommunications equipment under the GATT.

In the last round of multilateral negotiations that took place in 1979, the countries, the industrialized countries, deliberately kept telecommunications out of the Government procurement code, which in effect kept it out of the GATT. They put it in the same category as military equipment. That essentially means that every country that has an indigenous source of telecommunications equipment does not buy outside that source. That is why the trade deficit went negative.

Interestingly enough, the one country, which is the subject of the hearings today, that sided with the United States in attempting to bring telecommunications equipment under the GATT was Japan, and shortly after the Tokyo round of talks we were able to negotiate the famous NTT agreement, which was a bilateral agreement, which was necessary since no multilateral vehicle existed. It was a bilateral agreement between the United States and Japan that called for a nondiscriminatory treatment of U.S. suppliers in the Japanese market.

If you look at the chart that I submitted with my prepared statement, you will find the track record since 1980, which is basically when the NTT Agreement went into effect, and what you will find is that the trade imbalance with Japan increased to $1.8 billion in 1984, whereas the amount of sales to this theoretically open market went up very little.

Now, of course, the U.S. trend is easily explained by the fact that we continued, through a series of regulatory and legal processes, to open our market, while at the same time we basically had one customer in Japan, which was NTT, and while it was a theoretically open market, our experience in selling to NTT was less than successful.

What we found was that we could sell them some of our low technology items, such as telephone handsets, but they have consistently refused to buy some of the equipment that we feel represents our world leadership—things like satellites, satellite Earth stations, central office switching equipment—and these are the heavy duty items that could really make a difference in terms of the trade imbalance.

Then last year, Japan began to liberalize their own telecommunications market, and in December they passed a telecommunications bill which was aimed at restructuring and privatizing NTT and also permitting competition for the first time in the Japanese market.

In November I went over there to try to get some feel for what this meant in terms of our members, in terms of real market opportunities that might exist after the law went into effect. I met with NTT and I met with the Minister of Posts and Telecommunications, and I met with some of my counterparts in the trade associations and came away convinced that the situation after April 1 would not be significantly different for U.S. firms than the one that had existed prior to the passing of the new law.

I am now happy to report that that picture has totally changed. The U.S. negotiators were far more successful in the course of the last 4 months in changing the picture in terms of technical reciprocity for U.S. companies and have presented us now with a picture as of 2 weeks ago which is considerably brighter than the one that was described to me back in November.

In fact, I was fortunate to go with the U.S. negotiating team as an industry adviser 2 weeks ago, in following up on Nakasone's final commitment on April 1, to go even further in meeting our requests for technical reciprocity.

I would have to say that over that period of time, from December until 2 weeks ago, the one most significant change that has come about which I feel personally—and not to put down the U.S. negotiators—but I feel the single most significant thing that has occurred in the last several months has been the attitude of the Congress in this trade issue. I don't think there is any question, as someone who has watched it very closely during the entire process, but that the reason we were successful 2 weeks ago in those final negotiations was that there was a tremendous amount of pressure being felt by the people on the other side of the table. In fact, it was clear to me before the week was out that they were under clear instructions that we were not to leave until we were satisfied and that we were willing to make a statement, which is accurate, that we had achieved technical reciprocity.

That means that American companies should have no more difficulty under the new administration in having their equipment technically qualified to be sold in the Japanese market than Japanese equipment has enjoyed in our market for the last several years, and we consider that a tremendous achievement. We compliment the Congress for the role that they have played in achieving it. Frankly, 6 months ago I was very pessimistic that anything like that could be accomplished.

Now, what does that really mean in terms of dollars? It certainly means that we now get a fair shot in terms of having our equipment certified, and I think it also will result in increased sales for the following reason: Because of the structure under NTT, equipment must be built to exact NTT specifications in order to be qualified for sale in Japan. Now that is no longer true, and so some of our innovative products that have been available here in the United States, but which were denied access in the Japanese market simply because they weren't built to NTT specifications, should now be able to be qualified under this new law and certified and hopefully sold.

Now, the unfortunate part about that is that many of these innovations have come from some of our smaller companies—entrepreneurs are quicker to innovate than larger companies—and because of the situation that has historically existed there, there is no real means of distribution. So until we can really penetrate the Japanese market, there have to be some basic structural changes made that will enable some of our smaller companies to address that market.

All of our larger members are in—AT&T, Northern Telecom, Inc., Motorola—everybody has gone over en masse in anticipation of this opening of the market. But certainly we have a problem in terms of some of the smaller companies being able to take on this responsibility.

In closing, I would just like to say that I hope that this initiative that has been taken on by Congress will be continued and that we can continue to work with the U.S. negotiators in continuing to try to take advantage of what I hope is a tremendous new opportunity for our industry.

[The prepared statement of Mr. McDonnell on behalf of the Information and Telecommunications Technologies Group of the Electronic Industries Association follows:]

BEFORE THE
SUBCOMMITTEE ON ECONOMIC STABILIZATION
OF THE
COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS
U.S. HOUSE OF REPRESENTATIVES
WASHINGTON, D.C.

STATEMENT OF JOHN J. McDONNELL

On Behalf Of The
Information and Telecommunications Technologies Group
Of The
ELECTRONIC INDUSTRIES ASSOCIATION

April 30, 1985

Mr. Chairman, I am John J. McDonnell, Group Vice President of the Information and Telecommunications Technologies Group (ITG) of the Electronic Industries Association. The ITG represents 100 U.S.-based manufacturers of telecommunications equipment who account for roughly 85 percent of U.S. production of telecommunications equipment. I appreciate this opportunity to appear before you today to discuss the serious trade problem which exists in our industry.

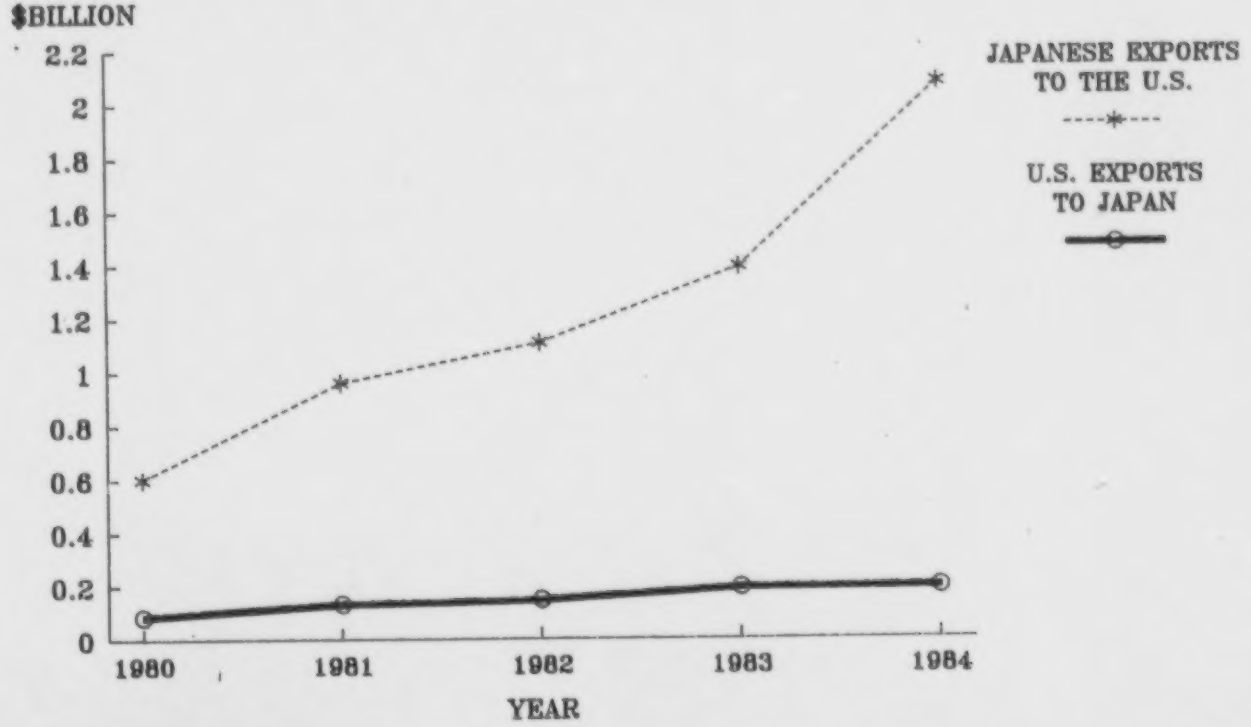
I represent one of this country's most competitive industries. The U.S. telecommunications industry is the world leader technologically. The firms in this industry have consistently maintained a high level of capital investment and research and development expenditures in order to remain competitive. Our industry is dynamic -- the number of firms in our industry grew from 380 in 1978 to 550 in 1983. Reflecting these strengths, we have been, and remain, strong supporters of a policy of free trade and open world markets. Unfortunately, however, in our sector this represents an ideal, rather than the actual state of affairs. At present, the only major telecommunications markets in the world which is open is our own domestic market.

The U.S. has been opening the domestic market to telecommunications equipment imports for many years, through a series of regulatory decisions that have progressively removed impediments to the sale of foreign products. With the breakup of the AT&T system in 1984 -- which severed the traditional supplier relationship between Western Electric and the regional Bell Operating Companies -- this process was completed, and our market was opened, virtually completely, to the sale of foreign equipment.

By contrast, the markets of our principal trading partners remain largely closed to our products. In most of these countries, the procurement of telecommunications equipment is dominated by government telecommunications monopolies (PTTs) which heavily favor indigenous suppliers. Our companies are effectively shut out of these markets, particularly in the "core" technology areas such as switching systems and transmission equipment, where we are most highly competitive. As a result, our industry's ability to achieve export growth is limited largely to developing countries which do not have indigenous suppliers to protect. Reflecting this imbalance in competitive opportunities, despite the U.S. industry's technological leadership, we ran a $608 million trade deficit in 1984.

The biggest single factor in this deficit is our bilateral trade balance with Japan, and I address Japan at some length today only for that reason. Figure 1 illustrates the U.S.-Japan balance of trade in communications equipment. As you can see, U.S. exports to Japan have shown virtually no growth in the past five years, despite the fact that Japanese consumption has grown at a rate of about 7 percent a year -- in effect we are losing,

FIGURE 1
U.S. JAPAN TRADE IN COMMUNICATIONS EQUIPMENT



SOURCE: U.S. Department of Commerce
SIC Nos. 3661, 3662

rather than gaining market share. By contrast, Japan's exports to the U.S. have grown phenomenally -- last year, over $2 billion in Japanese telecommunications gear was sold in the United States.

Japan's telecommunications market has traditionally been dominated by Nippon Telephone and Telegraph (NTT), the national telecommunications monopoly, which procures the bulk of Japan's telecommunications equipment -- its procurement budget is about $3 billion a year. Like other foreign PTTs, NTT traditionally bought only from domestic producers. In 1981, however, Japan entered into a bilateral agreement with the U.S. to open NTT's procurement to foreign products on a competitive bid basis. Japan was the first, and at present is still the only, foreign country to make this type of formal international commitment to nondiscriminatory telecommunications procurement.

Nevertheless, as Figure 1 indicates, U.S. telecommunications exports to Japan did not increase significantly after this agreement. NTT's President, Dr. Shinto, who took office when the 1981 agreement became effective, made a strong commitment to nondiscriminatory procurement and has implemented a number of programs to increase NTT's foreign sourcing. Under his leadership, NTT took affirmative steps such as the publication of bid specifications in English and the sponsoring of seminars in the U.S. on NTT procurement procedures. NTT opened an office in New York and began publishing notices of procurement opportunities.

Nevertheless, despite these and other such measures, U.S. sales remained low. Some observers attributed this phenomenon to the continued resistance of the middle-level NTT bureaucracy to the purchase of foreign equipment, notwithstanding Dr. Shinto's policy. As one Japanese official put it in 1982,

> [T]here are still elements within NTT that oppose importing American equipment.[1/]

In 1984, the Japanese government enacted new legislation which would partially transfer NTT's ownership to private hands and open up some types of telecommunications services to competition by private firms, effective April 1, 1985. The U.S. government became aware, however, in late 1984, that many features of this market restructuring could potentially operate as new barriers to U.S. products. For example, the Japanese government proposed to establish a body, made up in part of representatives of Japanese telecommunications equipment firms, which would inspect foreign customer premises equipment and decide whether or not it would be certified for use in Japan. Our competitors would, through this mechanism, control access to their own market. Similarly, the proposed standards for certifying equipment for use in the Japanese market were far more stringent than needed to protect the network, a factor which we believed could operate as a serious market barrier.

[1/] MITI Minister Shintaro Abe in Business Week, August 9, 1982, p. 42.

Our government expressed concern over these proposed regulations, and a series of intense bilateral negotiations followed. The Japanese government was at first unwilling to significantly modify the new ordinances and regulations which would regulate foreign access to the Japanese market. However, our negotiators displayed extraordinary tenacity and skill throughout this frequently frustrating process. The Congress took an increasing interest in the negotiations, and expressed its concern over the apparent lack of progress. In the past month, substantial progress has been made -- more so than I ever would have thought possible when these negotiations began.

In the most recent round of negotiations in Tokyo on the standards governing certification of U.S. equipment for sale in Japan, I participated as an industry advisor. In the end, the Japanese government agreed to delete all significant aspects of the proposed certification standards which the U.S. side found objectionable. These changes and other Japanese commitments which have been made during the past two months will significantly enhance the ability of U.S. companies to have their telecommunications products approved and sold in Japan. The entire industry is indebted to the U.S. negotiators for the outstanding efforts they have made on our behalf during the past months. There is no question that if these commitments are fulfilled, there will be a market for innovative U.S. products which were precluded under the old scheme.

At the same time, however, I would like to stress that nothing that has occurred thus far in these negotiations necessarily means that our firms will achieve even one more dollar in additional sales in Japan. Our industry has cited numerous formal and informal barriers to market access in the past which have impeded their sales efforts; these could continue to restrict U.S. sales despite the existence of product approval standards and procedures which are now nondiscriminatory. In fact, we uncovered several tariff barriers during the recent trip to Tokyo. These barriers have been brought to the attention of the Japanese government. In this connection it should be emphasized that the first round of these talks has not been aimed at increasing U.S. sales, but simply at achieving regulatory parity. Phase II will address other issues, including additional barriers.

Achieving the elimination of formal barriers is necessary, but it is not by itself enough, as our own experience has shown. We were under the impression in 1981 that an agreement had been reached which would open the Japanese market to our products. In that case, we appear to have been mistaken. That is why we now take the position that concessions such as those which Japan has recently made -- that is, the elimination of formal barriers -- do not necessarily mean that the market is really open, and that the true indicator of openness will be an actual increase in U.S. sales which reflects the competitiveness of our products. That is in fact what happened when we opened our own market -- imports increased dramatically, virtually overnight. We are skeptical that this sort of rapid change in trade patterns will occur in Japan. We believe, in light of our long experience, that only a comprehensive positive action plan by the Japanese government to overcome embedded barriers to foreign telecommunications products and to promote increased purchases of foreign products will produce a significant increase in U.S. sales in Japan.

The U.S.-Japan telecommunications negotiations are now moving into a new phase. Now that the discussions of the regulatory structure of the Japanese market are drawing to a close, the U.S. government will be monitoring the actual sales of U.S. products in the new, partially-deregulated Japanese market structure in order to determine whether additional barriers to U.S. sales exist.

I should note in this connection that NTT's Director General of Procurement recently met with ITG representatives. He told us that with NTT's entry into the private sector, NTT was very interested in procuring foreign products that were competitive in price and quality. He expressed a hope that more American companies would submit bids in the future than has been the case to date. He also said that while he believed that NTT was already nondiscriminatory, because the cultural differences between Japan and the U.S. are so great, NTT may still inadvertently be doing things which constitute barriers to U.S. sales. He hoped that we would bring these things to NTT's attention so that they can be corrected. We welcome these overtures, and as an industry, we will be responsive.

Our continuing concern, however, is that Japanese exports to the U.S. are increasing dramatically -- up by over $600 million in 1984 -- while we face, at best, the prospect of a painfully slow incremental increase in sales in Japan. The danger exists that by the time the Japanese market has opened significantly, our domestic industry will have been substantially eroded. By that point, of course, the question of our gaining market access to Japan may have lost much of its relevance.

While I have principally addressed Japan today, it is only because Japan is our biggest competitor. We face similar problems, however -- so far on a smaller scale -- all over the world. A number of European telecommunications markets are arguably more closed than that of Japan. In fact, Japan has made formal market-opening commitments, in the form of a bilateral agreement, that no European country has thus far been willing to make. Moreover, it is quite possible that European exports to the U.S. will increase sharply in the near future, creating the same sort of bilateral trade imbalance that now characterizes our trade with Japan. Opening the Japanese market will not, by itself, solve the problem. The telecommunications trade problem is global in scope, and it needs to be resolved soon if the deteriorating trade balance is not to result in the erosion of the U.S. telecommunications equipment industry.

The Congress has an important role to play in this process. It is our hope that this year the Congress will enact the comprehensive legislation which is needed to restore the balance of competitive opportunities. A number of legislative proposals addressing the telecommunications problem have been introduced or will be introduced in this session of Congress, and the ITG will be active in assisting the Congress in shaping legislation that will address the trade problem effectively. The ITG does not seek legislation which would close the U.S. market to foreign products; we will, however, support legislation that is aimed at opening foreign markets to our own products, if necessary, through the application of appropriate sanctions.

I might add that some while government measures are needed to open foreign markets to our products, we, the industry, also bear a major responsibility. When U.S. negotiators secure concessions -- as they recently have -- which improve the prospects for U.S. sales, we must make the sales efforts necessary to take advantage of the export opportunities which our government has opened up. It is not enough for us simply to criticize foreign countries for not buying our products. We must offer them a competitive alternative to their traditional domestic suppliers. This is a challenge and a responsibility which we accept.

In the recent negotiations with Japan, our domestic industry and our government worked together effectively. It is a good beginning, and I hope that we can build on it during the coming months. We must continue to work together -- industry, Congress and the Executive -- in order to resolve the dangerous imbalance in market opportunities that has been created in this sector. I look forward to working with you and other members of Congress on this issue in the coming months.

Chairman LAFALCE. Thank you very much, Mr. McDonnell. Before we question you, we will hear from the other panelists, though, and now Ronald Myrick, vice president, semiconductor programs for Mostek/United Technologies Corp., representing the Semiconductor Industries Association at this hearing.

Mr. Myrick.

STATEMENT OF RONALD E. MYRICK, VICE PRESIDENT, SEMICONDUCTOR PROGRAMS, MOSTEK CORP., CARROLLTON, TX, REPRESENTING THE SEMICONDUCTOR INDUSTRY ASSOCIATION

Mr. MYRICK. Thank you, Mr. Chairman.

I am testifying today on behalf of the Semiconductor Industries Association, which consists of 52 member companies, representing 95 percent of total U.S. semiconductor production.

It is very appropriate that the SIA has been asked to testify at this hearing, and we thank you very much for that invitation.

Our industry is a world class industry, we believe. American firms have been the technological leaders in the semiconductor industry since the semiconductor was invented in the United States in the late 1940's. Virtually all major product developments since then have also been made by U.S. companies.

The U.S. semiconductor industry is dependent upon foreign markets for 30 percent of our sales, thus our interest. Because of this dependence on export markets, we are also one of the strongest supporters of free trade. Last year, we lobbied strenuously and successfully to eliminate U.S. tariffs on semiconductors in combination with Japanese elimination of those tariffs as well. The tariffs of both nations were eliminated, effective March 1 of this year.

But we never expected the elimination of the tariff, which was then only 4.2 percent, would result in an increase in U.S. semiconductor sales in Japan. Other far more basic forces prevent the Japanese semiconductor market from responding to market forces and control the share of the Japanese semiconductor market which U.S. firms are able to obtain.

In the past we have experienced much larger tariff reductions, elimination of quotas, exchange rate fluctuations of up to 44 percent in a 2-year period, and several Japanese initiatives, so-called, to increase imports.

The most important of these initiatives was the November 1983 semiconductor recommendations of the United States-Japan High Technology Working Group. In that agreement, the Government of Japan committed to encourage Japanese companies to purchase more U.S. semiconductors, and U.S. companies agreed to make major efforts to service the Japanese semiconductor market.

There is evidence that the Government of Japan carried out its efforts to encourage increased purchases of U.S. semiconductors during the last quarter of 1983, but never renewed its efforts.

For our part, over the past 2 years, SIA member companies have engaged in a concentrated effort to increase our sales in Japan. This is indicated by increases in U.S. companies' sales forces, by the degree of seniority of the executives who head the U.S. companies' Japanese operations, and by the number of annual visits to Japan of senior U.S.-based corporate executives.

But it is best indicated by the fact that during the period of great semiconductor shortages during late 1983 and early 1984, U.S. companies allocated an increased percentage of their scarce products to the Japanese market at that time.

Throughout all these changes, U.S.-based companies' share of the Japanese market never left the 10- to 11-percent range for any extended period, and that is over many, many years. It is 10 to 11 percent for a constant level.

Yet in neutral markets, where we compete head to head with the same Japanese companies, we do very well. And neutral, I mean—by that, I mean neutral as between the Japanese and the Americans. For example, the European market in that respect is neutral, and there we have a 55-percent share of the market. In the rest of the world, outside Japan, the United States, and Europe, we have a 47-percent share of the market; whereas, in Japan we have an 11-percent share of the market.

If U.S. companies' share of the Japanese semiconductor market rose even to 30 percent, it would mean 27,000 more jobs in the United States; 4,000 of these jobs would be in my home State of Texas. Other concentrations would be, obviously, in California, Arizona, and New York.

Why are we not able to sell our semiconductors in Japan in a proportion commensurate with our competitiveness? Because of the structure of the Japanese market and an ingrained buy Japanese attitude.

More particularly, to counter the so-called liberalization of the Japanese semiconductor market in the mid-1970's, the Government of Japan encouraged the major Japanese electronics firms to work together, to divide the effort with respect to research, development, and production while sharing the results among themselves.

As a result, the same Japanese companies which manufacture semiconductors are the major consumers in Japan of semiconductors; 10 Japanese companies account for 60 percent of Japanese semiconductor purchases. Included in these 10 are all the significant Japanese semiconductor manufacturers.

In this structure, a buy Japanese philosophy was easily engendered and is now structurally entrenched.

In summary, we are clearly competitive, and despite major efforts we are clearly not allowed to participate fully in the Japanese semiconductor market. It will take more than encouragement of individual consumer purchases, as Prime Minister Nakasone has recommended, to remedy this problem. Individuals do not buy semiconductors, certainly not in quantity. In Japan, it is only a few large electronic companies which buy those semiconductors.

To remedy the serious semiconductor trade problem which has developed, SIA believes the U.S. Government should seek to achieve two commitments from the Japanese government:

First, that sales in Japan by U.S.-based semiconductor companies rise to a level reflective of the competitiveness of the U.S. companies. Those numbers I have already given you.

Two, to work with the U.S. Government to establish an effective system for the monitoring and prevention of semiconductor dumping in the United States. By that we mean sales at less than cost of manufacture, and here the investigations that would go into establishing this vehicle for monitoring would be very useful in setting forth things that are highly difficult for us to determine at this time, such as the vehicles used within Japan for the allocation of R&D expense, and so forth, to their cost of production.

The immediate semiconductor import goal should be to achieve within 1 year a dollar volume equal to the dollar volume shipped by Japanese companies to the United States. This would represent a strong first step toward a level of semiconductor imports which would occur if the Japanese market responded naturally to market forces.

On the second point, SIA urges the development of an effective cost-price model similar to the trigger price mechanism which has been used to identify and control dumped or subsidized steel imports. This should cause Japanese semiconductor manufacturers to reevaluate their investment plans if those plans rely on sales below cost in the United States.

My time is up, and I am finished. Thank you very much.

[The prepared statement of Mr. Myrick on behalf of the Semiconductor Industry Association [SIA] follows:]

BEFORE THE COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS
SUBCOMMITTEE ON ECONOMIC STABILIZATION

U.S. HOUSE OF REPRESENTATIVES
WASHINGTON, D.C.

HEARING ON JAPANESE MARKET ACCESS BARRIERS

STATEMENT OF
RONALD E. MYRICK
VICE PRESIDENT, SEMICONDUCTOR PROGRAMS
MOSTEK CORPORATION

ON BEHALF OF THE
SEMICONDUCTOR INDUSTRY ASSOCIATION

APRIL 30, 1985

Revised final version

Mr. Chairman, I am Ronald E. Myrick, Vice President, Semiconductor Programs, of Mostek Corporation, a Texas-based manufacturer of semiconductors and other advanced electronics products. I am here today on behalf of the Semiconductor Industry Association (SIA), which represents fifty-two manufacturers of semiconductors, accounting for over 95 percent of all semiconductors fabricated in the United States annually. I appreciate the opportunity to appear before your Subcommittee today.

At the outset, I would like to commend your choice of topic for these hearings, which is Japanese trade barriers and their impact on the competitiveness of U.S. industries. This is particularly important at a time when the Government of Japan has once again set into motion a major campaign to increase that nation's imports of manufactured goods. This campaign is aimed particularly at reducing Japan's bilateral trade deficit with the United States - a deficit which reached $37 billion during 1984. Yet thus far the Government of Japan has shown no inclination to emphasize the importation of industrial goods, such as semiconductors, as an element of its import promotion effort. Instead the emphasis has been on consumer products. Because of this deficit, there is little likelihood that there can be a major positive effect from this program, either in size or duration.

SIA wishes to see this emphasis in the Government of Japan's import promotion program changed. The bilateral U.S.-Japan trade situation in semiconductors reflects very clearly that Japanese companies have free access to the U.S. semiconductor market and have taken advantage of that access by increasing their market share in this country. At the same time, U.S. companies do not enjoy full participation in the Japanese semiconductor market, and there has been no significant change in U.S.-based companies' share of that market since the mid-1970s when Japan's official barriers to semiconductor imports were removed.

The U.S. semiconductor industry, therefore, confronts a major long-term trade problem, but one which SIA views, most fundamentally, not as an import problem, but as a problem of foreign market access. I would like to explain SIA's analysis of that problem, and provide some perspective as to how foreign market barriers adversely affect our economy over the long term.

The U.S. semiconductor industry is one of this country's most successful international competitors. The industry has always been, and remains, the world leader technologically. The semiconductor was invented in the United States, and virtually every major breakthrough in semiconductor technology has been made by American companies. The U.S. industry has outperformed its foreign rivals in most foreign markets.

In significant part, this reflects the fact that the U.S. semiconductor industry has made the necessary commitments to research and development, to capital investment, and to the pioneering and commercialization of new technologies. This industry reinvests most of its profits. As a percentage of its sales, it spends more on R&D than any other U.S. manufacturing industry. The industry recognizes that if it fails to sustain these efforts -- if it loses its edge in efficiency and innovation -- it will inevitably confront a trade problem that no government program can solve. In speaking of the trade problem which this industry faces today, therefore, I do so cognizant that the principal responsibility for remaining competitive internationally lies with the industry itself.

As you no doubt are aware, our principal competitive challenge comes from Japan. With considerable help from their government, Japanese semiconductor producers have made great strides over the past decade, and have actually succeeded in dominating the world market in several semiconductor product lines, such as random access memories. Nevertheless, overall, U.S. companies have consistently outperformed the Japanese all over the world -- outside of Japan. In Europe, for example, which can be considered essentially neutral in terms of potential national bias as between U.S. and Japanese suppliers, U.S. companies held 55 percent of the market in 1984 and Japanese companies only 12 percent -- we outsold them by better than 4 to 1. Similarly, in the world market, excluding the U.S., Europe and Japan, U.S. companies held a 47 percent share in 1984 while Japan achieved only a 29 percent share.

Japan itself is the one major world market where the U.S. semiconductor industry has not enjoyed competitive success against Japanese producers. The U.S. share of the Japanese market has never exceeded 10-11 percent for any sustained period -- Japanese producers account for all the rest. Thus, while U.S. companies outsell Japanese companies by 4 to 1 in Europe and

3 to 2 in the world outside the U.S., Europe and Japan, they outsell us by nearly 9 to 1 in Japan. This dramatic contrast between the U.S. success against the Japanese worldwide, and U.S. companies' poor showing in Japan strongly suggests the presence of market barriers. Indeed, barriers do exist. They are the most formidable that U.S. industry faces in any major world market. It is worth looking at what they are, how they came into being, and what their purpose and effect are.

The Protected Japanese Market

In the 1960s Japan's Ministry of International Trade and Industry (MITI) established as a major national goal the development of an indigenous information industry, including a semiconductor sector. To achieve this goal MITI imposed strict restrictions on the import of foreign-made semiconductors and on foreign investment in the industry. At the same time, foreign technology was imported, and MITI sponsored a series of intensive industry-government R&D projects designed to enhance the level of Japanese technology. The major electronics firms were encouraged to work together and to divide the effort with respect to research, development and production, while sharing the results.

The restrictions on semiconductor imports were inconsistent with the rules of the General Agreement on Tariffs and Trade (GATT), and in the early 1970s the U.S. government put strong pressure on Japan to eliminate these restrictions and open its market. The Japanese government agreed to end its import and investment restrictions, but only in stages stretching out over several years.

Moreover, Japan's progressive "liberalizations" of its import and investment restrictions were accompanied by MITI's "liberalization countermeasures" designed to offset the effect of the lifting of restrictions. These countermeasures included MITI pressure on Japanese purchasers of semiconductors to "buy Japanese", and the launching of a new generation of subsidized research and development projects.

In part, because of these countermeasures but also because of the market structure created under the watchful eye of the Japanese Government, even after the last formal restrictions on semiconductor imports and investment were eliminated in 1975, the U.S. share of the Japanese market showed virtually no improvement. Although U.S. companies committed major resources to developing the market, our market share has remained in the vicinity of 10-11 percent. A 44 percent appreciation of the yen against the dollar between 1978 and 1980 had only a marginal effect -- our share rose briefly to 14 percent in 1979, then returned to the 10-11 percent level.

At present, as was the case a decade ago, U.S. companies' sales in Japan are largely limited to products the Japanese do not make themselves. In 1984, the U.S. industry's share of semiconductor sales in Japan -- 11 percent -- was virtually unchanged from its share during the era when the market was formally protected.

What is the nature of Japan's market barriers today? Japan's largest semiconductor consuming companies are also the leading semiconductor producers. These firms, in effect, control both supply and demand, and have a collective interest in "buying national". Their propensity to do so has been reinforced by many years of government efforts encouraging them to undertake joint research and development, to effectuate a division of effort between companies, and to favor Japanese-made products in their purchasing decisions.

The U.S. semiconductor industry has devoted a major effort to surmounting these barriers. Many U.S. companies have established semiconductor sales and manufacturing facilities in Japan. The size of their sales forces and resource commitment has grown substantially.

In 1982 the U.S. government, backed by the U.S. semiconductor industry, began to mount a strong effort to reduce Japanese market barriers. A long series of bilateral negotiations was conducted by the two governments in the so-called High Technology Working Group, which was set up to address trade issues in the high tech industries. Between 1982 and early 1984, most of the High Tech Group's efforts were devoted to semiconductors, and primarily to the problem of market access in Japan. The negotiations represented one of the most significant market-opening efforts undertaken by the U.S. government with respect to Japan in many years. It has been a genuine effort reflecting a partnership between the U.S. government and our industry to solve this problem. The problem has been given the maximum attention by truly dedicated and professional officials of our government. What have the results been?

In late 1983, after sustained U.S. government pressure, the Japanese government agreed to take affirmative steps to increase U.S. sales in Japan. Specifically, the Japanese Government consulted with the major Japanese semiconductor consuming firms about becoming more open to purchases of competitive foreign products. At the same time demand increased generally -- SIA saw U.S. sales increase perceptibly in Japan, and U.S. companies reported that Japanese firms were responding to the two governments' interest in semiconductor trade by increasing their sales inquiries with U.S. firms. Nine SIA companies surveyed by SIA reported that their sales in Japan increased from $92 million in the fourth quarter of 1983 to $134 million in the first quarter of 1984. This seemed to be an encouraging beginning, perhaps a real breakthrough. However, the increase in sales occurred during a worldwide boom in semiconductor sales. Supply was tight in Japan and all over the world. While SIA companies could have sold all of their chips to U.S. customers at that time, U.S. companies made special efforts to maintain and in fact increase the supply to the Japanese market during the tight-supply period -- such was our concern with achieving a greater presence in that market for the long term.

The real test of the market opening measures would come at the end of the tight supply period. Would the Japanese continue to buy U.S. product when that period ended? By late 1984, semiconductors were abundantly available from Japanese sources, and U.S. firms' sales in Japan were off sharply. Fourth quarter 1984 bookings for new sales by the sample of nine SIA firms were lower than in any quarter since 1982. Overall, SIA companies experienced no net gain in market share for the year 1984, and the situation continued to deteriorate during the first quarter of 1985.

So, to sum up this recent experience, after the most intensive negotiating effort mounted by the U.S. government in any sector in many years, the net result was that we saw a perceptible increase in our sales for one quarter, followed by a reversion to prior levels. The net long-term impact has been zero. This market is still not open; nor, after last year, can I even say that it is beginning to open. The U.S. industry is really little better off today, in terms of share of the Japanese market, than when that market was formally protected by quotas and similar restrictions.

This problem is more than simply an exasperating situation faced by a U.S. industry overseas. Ultimately, it means foregone revenues and profits by U.S. companies, reduced employment levels, and, potentially, the erosion of our manufacturing base. I would like to be a bit more specific on these points.

The Cost to the U.S. of Japanese Market Barriers

While it is impossible to measure the precise cost to this country of Japanese market barriers in semiconductors, it is possible to make reasonable estimates of foregone revenues and jobs. SIA has analyzed competition in "neutral" markets like Europe and Southeast Asia and assumed that if the Japanese market were truly open, with purchasing decisions made on the basis of market factors such as quality and price, U.S. semiconductor companies would obtain a share of the Japanese market roughly commensurate with our share elsewhere in the world.

The U.S. share of non-U.S. world markets, including Japan, is 30 percent. Arguably, however, a better measure is our share of non-U.S. markets, excluding Japan, since given Japanese market barriers, Japan is not a typical market. The U.S. share of non-U.S., non-Japanese semiconductor markets is 53 percent.

In 1984, if U.S. companies had achieved a 30 percent share of the Japanese market, the U.S. industry would have enjoyed added revenues of $2.4 billion. If U.S. companies had achieved a 53 percent share -- which is the average in the world outside the U.S. and Japan -- the U.S. industry would have achieved $4.2 billion in added revenues. Moreover, if the U.S. retained this enhanced share on an ongoing basis -- as it has done elsewhere in the world -- this gain would accrue to the U.S. economy every year, and would increase as the Japanese market grows in size.

Starting with these assumptions, SIA has analyzed what that added revenue would mean here at home. An increase in sales revenue of $2 billion would result in an estimated increase in semiconductor industry employment of 21 percent, an increase in R&D expenditures of 25 percent, and a growth in internal funds available for capital investment of 26 percent. Our economy would feel the benefit of the added capital and R&D expenditures year-after-year. If U.S. companies were able to increase their share of the Japanese market to 53 percent -- which is the U.S.

share of non-Japanese, non-U.S. markets -- these figures would be much higher.

These benefits would, of course, be felt most noticeably in the U.S. regions which have become centers of semiconductor high technology manufacturing, notably California, Texas, Arizona and New York. Looking only at the employment effect on our industry, if U.S. companies were able to achieve an additional $2 billion in sales annually to Japan, SIA estimates that the result would be an additional 9 thousand jobs in California alone, 4 thousand more in Texas, and 27 thousand nationwide.

I would like to make it clear, however, that the problem of market barriers in Japan is more than simply a matter of foregone revenues and jobs here in the United States. Japan's protected home market is ultimately a threat to the U.S. industry in the United States and in other world markets.

One of the most important characteristics of Japan's protected home market is that it provides a secure, comparatively low-risk environment for investment by Japanese semiconductor producers. In the past, we have seen that this environment gives rise to "capacity-expansion races" in which Japanese producers rapidly install major increments of production capacity with little reference to global demand trends. When periodic market contractions have occurred, the Japanese, possessing a large overhang of surplus capacity and inventory, have disposed of their surplus production overseas at deeply discounted prices which do not adequately reflect the costs of production. As SIA has documented in past studies, such periodic surges of low-priced Japanese semiconductor exports have inflicted severe damage on segments of the U.S. semiconductor industry, and have caused some U.S. companies to withdraw from key product areas, such as high density computer memories, altogether.

After each such experience during a recession, the U.S. share of world sales has contracted, and the Japanese share has grown. Another such export surge may now be imminent.

Japanese companies are currently investing in new semiconductor production capacity at a rate far higher than the historical rate of worldwide semiconductor demand growth. This suggests that they believe they can dominate the world industry by the end of this decade. Furthermore, with world semiconductor demand now contracting, there is a strong prospect that the pattern of past recessions will be repeated -- and that the U.S. industry may come under pressure in all world markets as Japanese firms attempt to dispose of their surpluses in a depressed market.

The best way to counter this dynamic is to gain real access to the Japanese market -- the same sort of access which Japanese firms enjoy in our market. Gaining such access to their market is not just a source of added revenue for our industry: rather, it is critical to ensuring our own industry's long-run competitiveness and survival.

The U.S. government and the U.S. semiconductor industry have devoted two decades of joint effort to expanding the U.S. market presence in Japan. To date, the results of that effort have been woefully disappointing. In SIA's view, the Japanese market remains a protected market, and Japanese protection continues to impose substantial costs and risks on the U.S. industry, and ultimately on the U.S. economy as a whole. However, SIA continues to believe that progress can be made through negotiations. We believe the United States should seek to achieve two objectives.

First, a commitment from the Government of Japan that sales in Japan by U.S.-based companies should rise to a level that is reflective of the competitiveness of the U.S. companies. At an absolute minimum, we believe that within one year the monthly dollar volume of U.S. companies' semiconductor sales in Japan should equal the monthly dollar volume of Japanese companies' sales in the United States. This would be a lesser result than would occur with free competition, but we are at a loss to see how the current Japanese system can otherwise be made to more nearly resemble free market performance in the short run unless some sort of quantitative performance targets are established. In the long run the solution to this problem is a restructuring of the Japanese semiconductor market to make foreign competition fully acceptable.

Second, a commitment that the Governments of Japan and the United States will work together to establish a system for the monitoring and prevention of semiconductor dumping (defined as sales below the cost of production) in the United States market. This will require the development of a basis for measuring costs of production in Japan.

On the first point, SIA has suggested that the Japanese Government should encourage Japanese semiconductor purchasers to be open to purchases (and actually make purchases) of competitive foreign products. The interim goal of this effort -- a way station to having trade flows reflect market forces -- should be U.S. sales in Japan rising within one year to levels no less than those of Japanese-based sales in the United States. To be effective, SIA believes the Japanese Government efforts should be ongoing, covering a broad range of Japanese companies. What we seek is the development of long term relationships between Japanese semiconductor users and U.S. semiconductor manufacturers. In addition, SIA urges that semiconductors should be one of the highest priority specific items to be addressed in the import promotion plans Prime Minister Nakasone has requested from 60 leading Japanese companies.

On the second major point, the avoidance of dumping, in the short term we would suggest that the United States and Japanese Governments develop and implement an effective semiconductor cost-price model similar to the trigger price mechanism which has been utilized to identify and control dumped or subsidized steel imports. Such a system was proposed in the U.S.-Japan High Technology Working Group to avoid the threat of the dumping of semiconductors. It could include a set of standard methods for the allocation of costs including R&D costs and capital costs. This should cause semiconductor manufacturers to evaluate their investment plans in light of the need to avoid sales below cost in the United States market.

A renewed effort by both governments is needed to address the problem of U.S. companies' access to the Japanese semiconductor market. In this regard, SIA would like to provide to this subcommittee a study we prepared on Japanese market barriers and another on policy issues for 1985 with specific recommendations for near term actions by the Administration and the Congress. Furthermore, the report of the President's Commission on Industrial Competitiveness contains many recommendations for both near-term and long-term actions which would enhance the international competitiveness of U.S. industry overall.

In conclusion, Mr. Chairman, I complement this Committee on its attention to these issues of great importance to the United States, and thank you for the opportunity to appear at this hearing.

Chairman **LaFalce**. Thank you, Mr. Myrick.

Our next witness will be Kent E. Calder of the Woodrow Wilson School of Princeton University.

Mr. Calder.

STATEMENT OF KENT E. CALDER, THE WOODROW WILSON SCHOOL OF PUBLIC AND INTERNATIONAL AFFAIRS, PRINCETON UNIVERSITY, PRINCETON, NJ

Mr. **Calder**. Thank you, Mr. Chairman. It is a privilege to testify today on the crucial subject of market access in Japan for American firms.

I deal with this subject, of course, at some length in my prepared remarks, which are based on several years of research, particularly on the political side of the market access question; that is to say, what is politically difficult for the Japanese, what is easier and what the nuances and the variations across sectors are. I would like to make three basic points relating to the market access question today.

The first is that we have powerful economic forces at work, pushing the United States and Japan into ever deeper interdependence with one another. These forces create major winners and also potentially losers in both countries, in Japan as well as the United States.

The winners are industries that have international competitiveness. The electronics industry is certainly one, while the auto industry and the securities industry are others. These are three Japanese industries that have benefited very substantially from interdependence and, as a result, have a strong stake in a stable fairly open trading system.

If the United States were to intensify pressures on Japan, the losers potentially also could be clearcut. There are areas such as agriculture and distribution which would suffer if barriers were dropped. But the Japanese system doesn't have a very efficient mechanism of sorting out the losers.

It is quite sensitive to the problems of those who are in difficulties. Its first impulse is to protect the weak, although adjustment assistance is another option often used.

The second point that I would want to make is that there are major changes underway in Japanese decisionmaking processes which I feel have major implications for market access in Japan, as well as for our modes of negotiating with the Japanese.

The most important one is perhaps the rising importance of politicians—that is to say, members of the Diet—in the Japanese economic decisionmaking process.

This is particularly true for the members of the ruling Liberal Democratic Party, who have now been in power for 30 years. There are three basic reasons, I think, for this rising importance of the LDP. The first is this length of time that they've been in office. They have gained over time greater control over promotion patterns in the bureaucracy. As a result, they have been able to develop study groups and get input of expertise that helps them really understand and define issues much better than they previously were able to. Bureaucrats ruled and politicians only reigned 10 years ago; now that's no longer so.

And, then, technological change, and an erosion of many of the old regulatory barriers to which Under Secretary Olmer and several other witnesses have alluded to led to intensified rivalries within the bureaucracy, which then threw a lot of issues into the hands of the politicians. In other words, they come to hold the balance of power on issues like VAN, software, and the liberalization of Japan's financial system.

These politicians have a range of different interests. Their interests coincide with our interests in terms of market access and liberalization, it seems to me, most closely in electronics, and, secondarily, in telecommunications. There is a certain degree of correspondence as well in the financial area.

I think that we have seen the imprint of current Japanese politics in Prime Minister Nakasone's recent statement in the pattern of concessions which he has made and the areas where he hasn't perhaps been so forthcoming.

Politically, of course, the problems are most severe for the Nakasone government in the wood products area. It's not surprising that Senator Packwood has been quite upset with how forthcoming Japan has been in that area. But there are other sectors where Japan is more flexible.

The other area where it seems to me there are some serious impediments politically within Japan is distribution. Major rationalization of the Japanese distribution system is really not in the cards because small business, increasingly lies right at the heart of the LDP political coalition even more than agriculture.

This change, this increasing importance of the LDP in Japanese policymaking, has some major implications for the prognosis we might have for progress on the market access issues. The politicians are pragmatical, generally. That's one thing I think we can say. There have been instances of their being less rigid than bureaucrats. This metal baseball bat case that was quite famous a couple of years ago is one such case. On some aspects of auto and finance negotiations they have been helpful. For them consensus is often less difficult than for bureaucrats. Politicians can strike a bargain more easily and more quickly in many cases.

And where their own interest groups are not affected, they can be really quite flexible and nonideological. In that sense, this increasing importance of the politicians, I think, has some promise, although their knowledge of and sensitivity to the United States is sometimes a problem.

Politicians are responsive to two particular sectors among the Japanese multinationals and big business—the auto industry, to some extent; and the securities industry. And securities has wanted liberalization, at least of the outward capital flows from Japan. And that has been as a consequence one area where the Nakasone administration has been able to move fairly rapidly, as last year's yen-dollar agreement and implementation demonstrates.

So, in conclusion, I would just emphasize that we have some sharp differences across sector in the capabilities of the Japanese to act on several of these issues which were in the Prime Minister's proposal. I tend to think that this proposal is really an opening gambit. His buy-foreign statement, in many ways, was certainly courageous, but it's the opening element of what might be in the Japanese eyes considered a much longer process of negotiation. The Prime Minister has, of course, promised more details by July, and we should watch carefully for them. I hope that, over time, we will be more sensitive to the political dimension in Japan, and particularly the importance of broader contacts with the LDP politicians who make many of the final decisions on market access.

Thank you.

[Mr. Calder's prepared statement follows:]

STATEMENT OF

KENT E. CALDER

WOODROW WILSON SCHOOL OF PUBLIC AND INTERNATIONAL AFFAIRS
PRINCETON UNIVERSITY

BEFORE THE
SUBCOMMITTEE ON ECONOMIC STABILIZATION
COMMITTEE ON BANKING, FINANCE, AND URBAN AFFAIRS
U.S. HOUSE OF REPRESENTATIVES

APRIL 30, 1985

Mr. Chairman, it is a privilege to testify today on the crucial subject of U.S.-Japan trade relations, and especially on the question of market access in Japan for American firms. Market access is a vital element in our effort to preserve a free but fair trading system, and has major strategic implications for our private sector as well. With the United States and Japan increasingly the preeminent powers in a wide range of high-technology and service trade areas, free competition across the Pacific based on mutual market access can be a powerful engine of creativity and growth for nations everywhere.

Market access in Japan is clearly important for Americans, and for the world. But to what extent is it really possible? That is one of the large questions which I have been pondering over the past five years of research on protectionism in both the United States and Japan. That is the question which I would like to address today.

In certain formal respects the Japanese market is remarkably open -- more open, indeed, than the markets of either Western Europe or the United States. Japan's tariff rates on manufactured goods, for example, average only 3 percent, compared to 4 percent in the United States, and 5 percent in Europe. Japan is the only industrialized nation never to have invoked the safeguard provisions of the Multi-Fiber Agreement to project its domestic textile industry, and it employs remarkably few quotas outside its notoriously protectionist agricultural sector.

Yet the pattern of imports into Japan has long been, and continues to be, highly skewed by sector -- shaped by comparative advantage, but often by conditions of politics and industrial structure within Japan as well. Japan has imported what it has needed but could not produce -- raw materials, food stuffs, and a limited range of consumer luxuries and high-technology capital goods. From isolationist impulses and the need to conserve scare foreign exchange, import substitution has long been second nature to Japanese -- they have searched the world for items of interest and produced them at home.

As Japanese industrial competitiveness has risen, as global energy prices have fallen, and as economic structure has shifted inexorably over the past decade toward non-resource intensive sectors like electronics which require few raw material inputs from abroad, the economic rationale for obsessive import substitution in Japan has become ever less compelling. Yet the psychology has been hard to break, and the institutional structures impeding imports and encouraging exports difficult politically to dismantle. It is these institutional and psychological dimensions which we must in the end deal with in promoting expanded market access for American products in Japan.

What is possible for American firms seeking access to the Japanese market. Why don't we sell more in Japan? There is no doubt that the major problem is the exchange rate. The dollar is simply too strong in trade terms; despite Japan's rising trade surpluses and our contrasting deficits, the yen does not rise, due to the massive scale of the offsetting Japanese financial flows to the U.S. in search of high interest rates. Experience indicates that Japanese manufactured imports do respond to some extent in the face of exchange rate changes; following the large yen revaluation of 1977-1978, Japanese manufactured exports during 1979-1980 increased by over $4.7 billion. With significant structural changes in key sectors such as telecommunications and pharmaceuticals having occurred since then, and with others underway, it seems likely that major new American advances into the Japanese market could be achieved, should a stronger yen and the erosion of Japanese trade barriers so permit.

Structural Dimensions of the Market Access Issue

As a fairly close observer of Japan's foreign economic policymaking over the past decade, I have found three central realities of Japanese economic and political structure to have particular bearing on American market-access opportunities there. The first of these is the organizational structure through which Japan's foreign trade is conducted. Roughly two thirds of all U.S.-Japan trade-including exports from the U.S. to Japan as well as vice versa -- is handled by Japanese firms. Preeminent among these are the nine general trading companies, of which Mitsubishi, Mitsui, C. Itoh, Marubeni, and Sumitomo are the largest. These nine handle around half of all the imports and exports which flow through Japanese airports and harbors, including an overwhelming share of commodity products such as coal, soybeans, textiles, and non-ferrous metals. The general trading companies can profit on either side of a trade transaction -- export or import -- but find it especially easy to handle commodity products, where transaction volume is high, transport and distribution economies of scale prevail, and after-service requirements are minimal. Their central role in the Japanese economy is a major reason that much of the recent expansion of manufactured imports into Japan has been concentrated in such commodity products areas as textiles and aluminum.

The trading companies' capacity to handle a broader range of imports into Japan -- together with the ability of other more specialized Japanese and American distributors to compete with these firms -- will crucially affect the prospects of expanded American exports to Japan over the next few years. So will the evolution of Japan's distribution system, to be discussed later in more detail.

A second major feature of the Japanese political economy, profoundly influencing market access for American firms, has been the central role of the bureaucracy, and its connections to the broader business world. This role is characterized by striking differences among Japan's major ministries in the bureaucratic gains and losses from accelerated international trade. One segment of the bureaucracy, concentrated in the Ministry of International Trade and Industry (MITI), has historically stood between Japan and a turbulent world economy, deflecting, neutralizing, and at times accommodating foreign pressures, while also strategically guiding traded sectors toward international competitiveness. This segment is explicitly charged with international dealings, and benefits from carrying them out successfully. When trade frictions arise, it is often faulted within Japan for improper political management.

Other segments of the bureaucracy have been preoccupied mainly with domestic regulations, having little contact with foreigners, and little interest in international economic matters. Clientelistic relationships with domestic business, reinforced by the tradition that bureaucrats "descend from heaven" into the private sector by age 55, have made these domestically oriented ministries often quite protectionist. Growing bureaucratic ties with the political world also tend to reinforce this bias.

Over the past decade the scope of trans-Pacific economic transactions has broadened dramatically into telecommunications, pharmaceuticals, and other areas which have historically not been traded sectors for Japan. Officials administering these newly opening sectors have often been less sensitive to foreign requests, and less aware of the long-run strategic importance of open international markets to Japan, than those at the ministries coordinating the affairs of internationally traded sectors. Not coincidentally, these formerly non-traded sectors, administered by bureaucrats with little stake in open markets, have witnessed some of the more severe trade frictions over the past few years, and may well do so in future as well. In some cases -- at the Ministry of Posts and Telecommunications, for example, technological and economic forces integrating national markets have made bureaucrats formerly preoccupied with domestic regulation increasingly conscious and sensitive to foreign viewpoints. This trend should be encouraged.

To a greater degree than government officials in many of the Western European nations, Japanese bureaucrats have understood and worked with markets. Indeed, for over fifty years they were forced to do so, since Japan did not have full tariff autonomy for a half century up to 1911. But the meaning of markets for Japanese officials has been traditionally much different than it has in this country. Few of them have seen markets as an end in themselves -- markets are to be used strategically, to encourage efficiency and improvements in product quality, or to force shifts in resources allocation beneficial to the Japanese economy as a whole. This conception of markets clearly decreed scaling back the textile industry of the 1970s through expanded imports. But its implications for market access in telecommunications or electronics are not so clear.

A further crucial point about Japanese bureaucrats is their preferred mode of operations. Case-by-case understandings, based on continuing personal relationships, are the heart of their interaction with the private sector. Such methods of dealing are traditional in Japan; the case-by-case approach that avoids clear-cut legal principles while also maximizing bureaucratic power. The corollary of this mode of operating is that Japan's government officials strongly desire to deal personally with a small number of executives from a relatively fixed group of large companies. They dislike unstructured, chaotic situations, such as those produced by markets in the normal Western sense of the term. They tend to find dealing with U.S. multinational corporations long resident in Japan easier than outsiders often suppose. The real problem is in fitting new firms, especially smaller ones, into their system of tight on-going personal ties.

A third feature of the Japanese economic and political landscape, which deeply affects the market access prospects of foreign firms in Japan, is the ruling Liberal Democratic Party. The LDP's political base, its internal decision-making structure, and its role in Japanese policy formation are all now in the midst of complex and rapid transition. These changes have considerable implications for foreign firms doing business in Japan -- particularly those in the agricultural, financial and high-technology areas, as well as for U.S. negotiators dealing with the Japanese.

For many years after the Liberal Democratic Party's foundation and ascendancy to power in 1955, the maxim that "Politicians reign, but bureaucrats actually rule in Japan" was largely true. But this is no longer so. Thirty years in power, and astute management of personal relationships with the bureaucracy, has given LDP politicians considerable influence over promotion decisions within the bureaucracy.

LDP Dietmen are developing much deeper substantive familiarity with major policy issues than previously, in part aided by "study groups" of younger bureaucrats and academic advisors who sense the rising influence of the political world.

Finally, technological change and the erosion of regulatory barriers in crucial emerging sectors of the political economy such as telecommunications and finance are intensifying bureaucratic rivalries over jurisdiction, and thrusting decisions into the hands of the LDP for resolution. The role of these politicians tends to be especially crucial in structuring issues at the early, informal stage of decision-making. This is a stage at which U.S. negotiators had traditionally not been involved in influencing the Japanese policy process, until some major breakthroughs by USTR and Commerce Department negotiators last year. Understanding the internal dynamics of Japan's ruling Liberal Democratic Party and the considerations which shape its stance on policy matters will be increasingly crucial in assessing market access opportunities for American firms in Japan, and it is fortunate that U.S. negotiators are increasingly sensitive to this point.

Senator Packwood is certainly right that politicians everywhere have to make tough decisions on protection-related issues. But Japan's Liberal Democratic Party is unusually vulnerable to interest-group pressure, due to the nature of the Japanese electoral system and the strong intra-party rivalries which that system has generated among Japan's conservative politicians. Under the Japanese multi-member electoral district system, it is often possible to be elected with as little as ten to fifteen percent of the popular vote in a constituency. Shifts of one or two percent of the popular vote can often -- even more frequently than here -- be the difference between victory and defeat. So the backing of well-organized groups in one's constituency is especially critical. Each LDP candidate usually has between two and four other LDP rivals running against him in the general election. These rivals will be only too glad to pick up support from the well organized agricultural cooperatives, medical associations, construction unions or small-business groups, if he should fail to strongly support their demands.

Japan's unusual electoral system also generates strong pressures toward factionalism within the ruling LDP, since the rival candidates in local constituencies need independent sources of support in their competition with one another. Rivalry for Cabinet positions and the Prime Ministership intensifies this factional competition. These factions, in turn, undermine the ability of the Prime Minister to move decisively on policy matters, in the absence of a general consensus as to what ought to be done. The contrasts to our own strong executive system in this regard are quite striking.

Prime Minister Nakasone is especially vulnerable to the constraints which the Japanese political system imposes on any chief executive. His faction is among the weakest of the five major factions, holding only three of 21 seats in the current Cabinet. His major source of political support has been former Prime Minister Kakuei Tanaka, arguably Japan's most powerful politician, who helped him become Prime Minister in late 1982. Over the past fifteen years Tanaka has developed a network of political and bureaucratic supporters who flexibly solve a broad range of policy problems, as well as dominating the political process. But Tanaka has been hospitalized since mid-February, amid serious and growing doubts that he will ever be able to regain his previous political effectiveness.

The LDP's traditional political base, as is well known, has long been agriculture. This reality has often been blamed -- by both Japanese and Americans -- for the persistence of import controls such as those on beef and orange imports. Other factors, especially the strong vested interests of importers in a continued structure of controlled imports, appear equally important. In any event, farmers are steadily leaving the land, and the LDP's locus of political support is shifting steadily toward the cities. In 1980 farmers constituted only 17.8 percent of the LDP vote, while 44.5 percent came from urban and metropolitan constituencies. A new generation of urban oriented LDP leaders is also rising, albeit with some time lag behind the shift in the locus of electoral power. The current political strength of agriculture -- together with the fact that it is slowly waning -- suggests a gradualist approach to market access in the agricultural sector, while high-technology concerns are emphasized.

The new focal point of mass LDP political support -- the critical constituency of the 1980s -- is small business. Over half of all Japanese now work in firms of 30 employees or less, and around 8 million are actually proprietors. The owner managers of small restaurants, wholesale distributorships, and small factories are among the most important political constituencies of Japanese conservatism today. This reality makes some measures to improve market access, such as reduction in plywood tariffs and rationalization of the Japanese distribution structure particularly costly to the Nakasone Administration in political terms. It has little impact, however, on Japan's inclination to cooperate in areas such as improved incentives for foreign investment in

Japan, or expanded U.S. market access in areas such as electronics, which are dominated by large firms.

Another group which has risen in political influence over the past five years is the multinational corporation, with the rising power of automotive and securities firms especially noticeable. The largest auto manufacturers appears to have profited considerably from the restriction in trans-Pacific auto trade during the 1981-1985 period, which indirectly protected them from intense price competition from smaller Japanese makers. They have reportedly employed substantial portions of their additional profits in political contributions to the ruling party as well as other public affairs activities. Large banks and securities firms have also reportedly benefitted form the transition underway toward a more market-oriented Japanese financial system, and toward sharply expanded capital outflows from Japan since 1980. They are also reported to have been quite politically active of late.

These growing multinationals have a strong stake in a stable world trading regime. The prospects they see for rising Japanese global competitiveness in telecommunications, finance, and elsewhere during the last half of the 1980s make this stake in stability ever stronger. They could be an increasingly strategic force for moderation within Japan, should the current U.S.-Japan trade crises continue to deepen.

The Nakasone Liberalization Proposals

The implications of emerging political realities in Japan have been dramatically clear over the past month, as Prime Minister Yasuhiro Nakasone has struggled to create domestic consensus over liberalization measures. An initial bold proposal from the internationally oriented segment of the bureaucracy for rapid reduction of plywood tariffs was defeated within the Japanese policy process early in April. It was transformed into the much weaker suggestion that Japan would within three years begin the reduction of tariffs. By contrast, in the electronics area, where politically influential protectionist groups do not prevail, the Prime Minister proposed the mutual abolition of tariffs in the electronics sector, and conceded to the American insistence that software be protected under copyright law. The Nakasone Cabinet is also submitting a chip mask protection bill to the Diet, developed in apparent consultation with major U.S. semiconductor producers, which has also met with approval in this country. Both the flexibility and the rigidity in the Nakasone proposals thus reflect clearly the balance of political forces within Japan outlined above.

The most striking aspect of the Prime Minister's April 9 speech was, of course, his direct television appeal to the Japanese people to buy more foreign goods. Such a step has never been taken previously by a top Japanese leader, and seems to strike at the heart of American market access problems in Japan -- a perception in the mind of many Japanese consumers that buying foreign goods is somehow not patriotic or practical. The speech was carried off with a fluency which no recent Japanese leaders could have achieved. The Prime Minister seem to be personally sincere in his campaign, and has directed the Ministry of International Trade and Industry to meet with 60 major Japanese exporting companies to prepare comprehensive plans for increasing manufactured imports.

But initial assessments from Tokyo suggest that the program is meeting with some resentment internally within Japan, and may well meet with only limited success in the long run. The strong value of the dollar is a problem. In addition, both Prime Minister Nakasone and other government officials have natural political difficulty promoting the purchase of foreign items which compete directly with domestic products in the middle-price, medium quality sector of the consumer market which will determine the ultimate success or failure of the import drive. That leaves high-priced, high-fashion goods such as those from Italy and France which the Prime Minister himself bought during his publicized shopping trip last week as a primary focus of the import drive. Such imports do little for the U.S.-Japan trade imbalance, and do little to shake the deeply rooted Japanese perception that the only foreign goods Japanese can usefully and appropriately buy are those which do not compete with home-grown products. In addition, many Japanese consumers seem to feel only a limited need for such products, in view of their strong impulse to save for exorbitantly expensive education, housing, and retirement.

Despite the symbolism of his "buy-foreign" appeal, it seems clear that Prime Minister Nakasone has not yet confronted the moment of truth on current issues in U.S.-Japan trade. To be sure, in relation to electronics and to some extent telecommunications questions, his Administration has made significant steps which should not be minimized. But he does not appear to have intervened strongly and personally on controversial questions of importance in constructing the April 9 package -- in contrast to actions of his own, and other Prime Ministers, in the past.

Past history has shown that Japanese leaders can take decisive steps to defuse economic frictions with the United States, as Hayato Ikeda did in initiating liberalization of lemon imports during 1962, as Kakuei

Tanaka did in negotiating an agreement on textile trade with David Kennedy in 1971, as Masayoshi Ohira did in concluding the government procurement code agreement in telecommunications during 1979-1980, or as Yasuhiro Nakasone himself did just last year in bringing the Yen-Dollar Accord to fruition. To be sure, this is a delicate moment politically for Prime Minister Nakasone within Japan. But this does not gainsay the fact that he has expended relatively little political capital on the April 9 package. This no doubt is being conserved for the struggles of the coming weeks and months, both within Japan and abroad, should foreign dissatisfaction intensify. The promised July announcement of further market access program details will provide further opportunities for clarifying the Prime Minister's intentions.

Looking to the Future

With Japanese direct foreign investment rising to a cumulative total of over $61 billion in 1984, and with exports likewise rising sharply to $168 billion, Japanese multinationals clearly have a strong stake in a stable global trading and financial order. But that nation's decision-making processes are increasingly dominated by politicians neither conscious of or responsive to international dissatisfaction concerning Japanese economic conduct. To be sure, there are important exceptions, such as Foreign Minister Shintaro Abe, LDP Vice Chairman Susumu Nikaido, and LDP Telecommunications Committee Chairman Tetsuo Kondo. But aside from Prime Minister Nakasone, few politicians are willing to move ahead of public opinion, and to advocate market-opening positions which may be politically unpopular at home.

Japanese mass perceptions are thus a crucial aspect of the market access battle, as Prime Minister Nakasone and those U.S. officials who encouraged his television appeal have concluded. But altering those perceptions so as to make "buying foreign" more legitimate in Japan involves positive actions by the United States -- together with sustained pressure for market access in strategic areas. U.S. actions which address the pervasive sense of economic vulnerability that the Japanese feel could in the end help them move more rapidly toward the enhanced economic interdependence which "buying foreign" implies.

The psychological dynamics of Japanese protectionism were quite clear in the controversy this past month within Japan over reducing plywood tariffs. There are less than 150 plywood factories in Japan currently, 40 percent less than ten years ago. The industry is an insignificant source of employment, and a drag rather than a spur to economic growth. Yet a broad spectrum of agricultural and small business groups put strong pressure on the Government not to reduce tariffs, supported by 280 out of the 511 members of the Diet. The central reason for such fierce opposition, which ultimately defeated liberalization proposals, was the perception, as the Central Federation of Agricultural Cooperatives put it, that "If plywood is liberalized, at some point the United States will demand liberalization of rice imports." Were American policy goals more precisely specified, to reaffirm that the U.S. does not seek radical Japanese dependence on the outside world for foodstuffs, and will not, as the Nixon Administration did through the soybean embargo of 1972, capriciously interrupt Japanese supplies from the outside world, interdependence through expanded Japanese purchase of American goods might well expand more rapidly.

The crux of current U.S.-Japan market access negotiations centers, of course, on the four sectors specified by the Reagan-Nakasone understanding of January, 1985. Recent estimates suggest that implementation of all the U.S. proposed measures in these four sectors currently under negotiation might only result in a $5-12 billion initial annual reduction in the U.S. trade deficit with Japan. (U.S. Commerce Department estimates suggest $12 billion while Japanese private-sector estimates suggest $5 billion.) The $5 billion Japanese estimate is an amount roughly comparable to the balance of payments deterioration anticipated this year alone through termination of the 1981-1985 voluntary export restraint on autos. But even were this relatively low estimate to prove correct, the long-run effects of liberalization in these areas should be much more substantial.

In telecommunications, several developments create major new opportunities for American firms, provided that market access issues are resolved and competitive patterns in the Japanese market develop as expected. The most immediate is the recent privatization of Nippon Telephone and Telegraph, effective April 1, 1985. This creates prospects for expanded competition in the Japanese domestic telecommunications market, including the generation of new, innovative telecommunications services. Three newly created common carriers and a satellite communications service firm have already applied to the Ministry of Posts and Telecommunications to begin services as basic telecommunications carriers in competition with NTT. All three common carriers are planning to begin leased circuit services during 1986, and long-distance phone call and other general services during 1987. The satellite communications service firm plans to launch an American-made communications satellite in December, 1987, and another satellite in 1988. Its competition includes two rival satellite communications service companies which prospectively might launch U.S.-built satellites as well. Unless broader competition in international satellite services with Intelsat is authorized, however, it seems unlikely that all three Japanese firms would be in a position to operate independent satellite networks and hence to purchase satellites.

Although extensive plans for competition with NTT are being tentatively scheduled, some observers still doubt that they will come to full fruition. Some see quasi-monopolistic operating patterns continuing in the various sub-markets of telecommunications service. In this case the operation of market forces spurring innovation and drawing in imports in large quantities could be relatively restrained. The mere privatization of NTT alone does not assure strong competitive dynamics, it is argued; it only generates additional government revenues that might be available for public works and other purposes, through the sale of NTT shares. The forces which would like to create vigorous competition in domestic telecommunications are too weak to achieve this, some critics maintain. Much of the uncertainty which may currently exist regarding the competitive dynamics of the newly privatized Japanese telecommunications system may be substantially removed by late 1985. This year is one during which careful monitoring of competitive dynamics in Japanese telecommunications is imperative.

Other dynamics independent of the NTT privatization could also create major long-run U.S. market opportunities in Japan. Regulatory changes have already spurred the development of a major customer premises equipment (CPE) market over the past five years, in which American firms have some share, although much less than the reciprocal Japanese share in the U.S. CPE market. More importantly, Japan is in the early stages of deploying a massive new Information Network System (INS), which over the next decade will generate huge new demand for telecommunications equipment, software, and value-added network (VAN) services, which American firms could be in a position to supply. Total investments for the INS project are estimated at around $80 billion over the next twenty years.

In addition to business activities in Japan itself, American firms may be able to profit substantially from Japan-related expertise to strengthen competitive capabilities in mainland China, Korea, and Taiwan. One major growth market in these nations, as computer memory capacities and optial-fiber data-transmission capabilities grow, will be the storing, processing, and transmission of material in the form of Chinese characters. Expertise developed with kanji-processing techniques that is developed in the Japanese context may well be transferable to information-processing operations elsewhere in the region.

Pharmaceuticals also presents a potentially attractive target of opportunity, due to the technological sophistication of American firms, and the long-run expansion of the Japanese market. There may well be a major impending shakeout in the Japanese pharmaceutical industry, with American multinationals well placed to move in. Over the next fifteen years, Japan will experience the most rapid aging of any nation in the industrialized world, with the market potential in pharmaceuticals which that implies. The medical equipment market could potentially be attractive for the same reason.

Compared to pharmaceuticals, electronics, and telecommunications, the potential of the Japanese wood product market for the United States appears distinctly more marginal. Demand for lumber in construction is stagnating, due both to slow starts in the housing market, and extensive competition from other materials. Even should Japan substantially liberalize imports of wood products, U.S. firms would face stiff competition from Southeast Asian imports in many market segments. Yet land taxation changes with considerable latent popularity in Japan could trigger a housing boom which would nevertheless mean a substantial long-run market for finished American lumber in Japan.

The four sectors vary sharply, as suggested earlier, in the sort of political barriers to U.S. market access which they present. In wood products, tariffs are the key, since the products involved are relatively undifferentiated. Wood products is the sector where protectionist pressure are perhaps strongest within Japan, both due to the depressed state of the domestic sawmill industry, and to its affiliation with two of Japan's most powerful lobbies -- agriculture/forestry, and small business. Wood products benefits clearly from the growing role of the LDP in Japanese policymaking processes, as described above. Liberalization could probably in the end prove politically possible for the Nakasone Administration, but would require the provision of government subsidies as high as $500-800 million to plywood alone, during a period of already large government budget deficits. These would go to only 150 sawmill owners and a handful of other participants in the industry.

Pharmaceuticals likewise presents thorny political obstacles to profitable market access for American firms, although mostly in the form of non-tariff barriers. Research and development costs in this industry have been so high recently that both American and foreign pharmaceutical firms find spreading costs across several national markets through exports and overseas production to be crucial to international competitiveness. As a result, acceptance of clinical test data is important for its impact in reducing costs. Prime Minister Nakasone's indication that Japan will expand acceptance of U.S. test data was an important step forward in this regard. Another major market access issue relates to reimbursement rates for medical equipment and drugs purchased under the national health insurance system. These are determined by the Ministry of Health and Welfare, which has recently set them in ways which effectively discriminate against American products.

The telecommunications sector is the most politicized high-technology sector in Japan, although what this implies for American market access in Japan depends sharply on the issue. The Telecommunication Workers Union (Zendentsu), with over 290,000 members, is the largest industry union in Japan, and was relatively militant in opposing the government procurement agreements of 1979-1980. It also opposed the privatization of Nippon Telephone and Telegraph in its early stages. The so-called "NTT family," with a large concentration of small businesses who subcontract for the major electronics producers, is also powerful politically, and strongly opposed to accelerated foreign imports. Yet the "NTT family" is itself in the process of dissolution as NTT privatizaitcn puts NTT itself in potential competition with its former suppliers. Neither it nor the unions, in any case, have nearly the aversion to the entry of foreign firms in emerging high-growth telecommunications service markets, such as the value-added networks area, which they have had in the case of established equipment markets.

The telecommunications sector presents a political phenomenon which has become more and more pronounced in Japan over the past few years --

the fusing of political and bureaucratic interests into a potent "policy tribe," or zoku, which has strong control over the policy process. The unusually strong linkage between politics and administration in the telecommunications area was given a big boost in 1958, when former Prime Minister Kakuei Tanaka became Minister of Posts and Telecommunications. In subsequent years, Tanaka carefully cultivated the MPT, gradually developing a strong cooperative relationship with that ministry. MPT was powerful in its own right, supervising a network of 22,000 post offices across Japan which play a strategic role in their local communities, and can be mobilized to support joint goals of the MPT and the political world. Due to strong ties with powerful politicians and centralized administrative control over the awarding of cable TV franchises, the MPT has rapidly grown in influence. It is currently becoming a ministry capable of holding its own against such traditionally established bodies as MITI and the Ministry of Finance, and is playing a major independent role in U.S.-Japan trade negotiations.

The electronics sector has been demonstrably the most open of the four under negotiation, for the political and economic reasons outlined above. Most of the Japanese firms involved are the large multinationals such as Hitachi, NEC, and Fujitsu, with a vital stake themselves in the continued openness of the international trade system. The ministry supervising the sector is MITI, which possesses relatively great international sensitivity and a stake of its own in the prevailing world trade regime. Not surprisingly, the areas of greatest Japanese flexibility in the April 9 Nakasone announcement were in this area. And this may well be true in future as well.

Among various market access possibilities for the future, those involving expanded opportunities for U.S. foreign investment in Japan seem easiest politically for the Japanese to provide. Dealing with U.S. firms through Japanese nationals who work for local subsidiaries of these firms neutralizes much of the cultural complexity for Japanese government and business of interacting with a foreign corporation. In June, 1982 the Japan Development Bank extended its first loan to American firm, with its support of the Isahaya semiconductor plant of Fairchild, in Nagasaki Prefecture. More recently, U.S. small businessmen have begun receiving loans from the People's Finance Corporation, one of Japan's largest government financial institutions. Expanded government loans to U.S. firms operating in Japan, particularly in the context of investment projects in some of Japan's outlying rural prefectures, would no doubt encounter little resistance. The prefectures themselves clearly welcome American investment in most cases.

The prognosis for removal of key barriers to American exports is substantially more complex and clouded than that against barriers to investment. Rationalization of the distribution sector, through the expansion of the large supermarket chains which so efficiently and aggressively source large volumes of imports into the United States, is next to impossible in Japan, due to the considerable and rising political influence within the ruling LDP of small distributors. General trading companies would no doubt be able to handle larger volumes of imports, especially if a stronger yen made this profitable. But their extensive ties with domestic manufacturers often create potential conflicts of interest, as in the case of processed wood product imports. In high-technology service sectors such as software and value added networks, distribution per se does not provide such crucial obstacles. But linguistic differences and the need for customized adaptations to local Japanese circumstances makes on-shore modification in Japan by local subsidiaries often a crucial requirement.

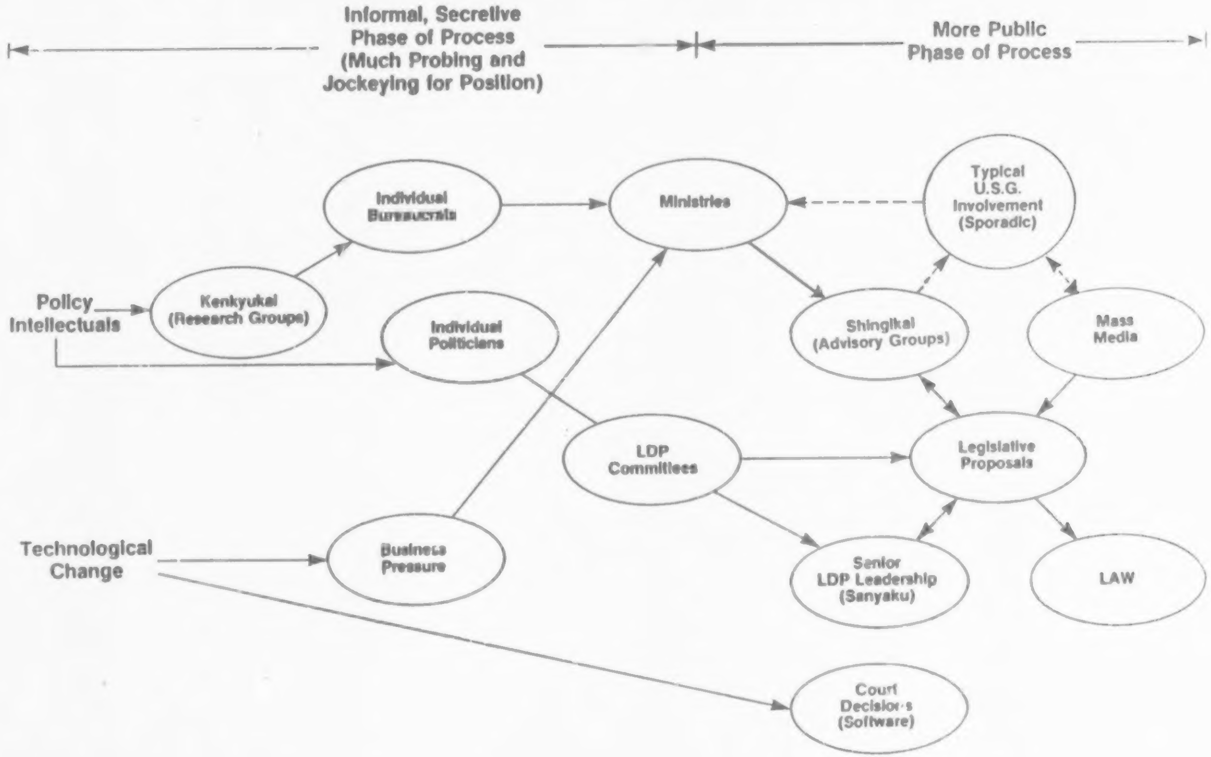
In some areas considerably expanded exports from the United States to Japan may well be in prospect. SONY has recently set an encouraging precedent with its announcement that its San Diego electronics plant would be exporting 300,000 color TV picture tubes back to Japan. Should exchange rates realign to reflect actual trade flows, this flow of "captive imports" into Japan from the U.S. could increase significantly, especially where distribution networke for the product in question already exist. American multinationals will no doubt also help expand U.S. imports into Japan, as they step up global sourcing for operations there.

The most critical problems regarding export market access to Japan are no doubt faced by the relatively small firm without experience in the Japanese market. For these businesses, more assistance may well be necessary. Especially in rapidly growing high-technology sectors, their active involvement in the Japanese market could contribute much toward reducing the massive U.S. trade deficit with Japan. Establishment of specialized trading houses in such areas as software and telecommunications under the new trading company legislation may be one approach which could enhance American prospects in the Japanese high-technology market.

One final means of expanding U.S. access to the Japanese market is the macroeconomic expedient of pressing Japan to expand domestic demand and reduce its propensity to save, as Secretary of State George Shultz has recently urged. This proposal has been the subject of considerable debate across Japan since mid-April, with LDP politicians marshalling it as justification for their self-serving view that public works spending should be substantially expanded. Public works have been held at below zero growth rates since 1982 to reduce the national budget deficit. Opposition to the Shultz proposal has come, predictably, from the Ministry of Finance and from critics who note the imminent and very rapid projected increase in Japanese elderly. They contend that Japan needs all the savings it can muster for an impending rainy day when retirements begin to increase rapidly.

Given the configurations of Japan's political system outlined above, it seems likely that the Nakasone Administration will embrace the Shultz reflation proposal, and establish that as a central element of its response to American demands for enhanced market access in Japan. The parallels to the Fukuda-Carter dialogue of 1977-1978 when Japan embraced the "locomotive theory" at U.S. urging, and deemphasized sectoral issues in the trade dialogue, are striking. Clearly more rapid growth in Japan would encourage higher levels of imports, and perhaps encourage exchange rate realignment as well. But it is crucial that this Congress and the Administration not neglect the importance of the structural dimension. Institutions and ways of thinking built up over centuries to insulate Japan from the international economy cannot be dismantled in a day. But in the end, they must inevitably be reshaped under the impact of forces creating the era of trans-Pacific interdependence which is now dawning.

Figure I: Typical Japanese Policy Making on Information Processing Issues


Informal, Secretive Phase of Process (Much Probing and Jockeying for Position)
More Public Phase of Process
Policy Intellectuals
Kenkyukai (Research Groups)
Individual Bureaucrats
Individual Politicians
Technological Change
Business Pressure
Ministries
LDP Committees
Typical U.S.G. Involvement (Sporadic)
Shingikai (Advisory Groups)
Mass Media
Legislative Proposals
Senior LDP Leadership (Sanyaku)
LAW
Court Decisions (Software)

Chairman LaFalce. Thank you very much, Mr. Calder.

Do you have any thoughts as to why the bilateral agreement we entered into with respect to correcting the dollar/yen relationship has not produced much result?

Mr. Calder. Well, my basic initial response there would be that the savings rate in Japan is extremely high, relative to what it is here. And, in this country, we have a large budget deficit and, as a consequence, high interest rates.

So this creates a basic economic situation that would cause capital to flow from Japan to the United States. The Japanese, of course, since 1980, have engaged in a major liberalization of outward capital flows. In other words, they have made it much easier for their insurance companies and corporations to invest in our capital markets, and so on.

That liberalization of restriction on the outward flows from Japan has enabled them to take advantage of the underlying economic situation—that is, the difference in the supply and demand for capital in the two markets.

So I would say that those liberalization decisions which they made during the past 4 years have, in the context of the basic interest rate situation, had a significant effect on the exchange rate.

Chairman LaFalce. Mr. Myrick, you have stated that we should obtain a commitment from Japan that sales in Japan by U.S.-based companies should rise to a level that is reflective of the competitiveness of U.S. companies.

How would one determine what that level should be?

Mr. Myrick. That's an excellent question. In my written testimony, I've got some numbers there that you can refer to. And also, SIA has prepared a study which we can supply to you as well.

The basic reference that we use for determining those numbers is the reference of: How do we do it everywhere else?

And that's the reference I was making in my testimony to the fact that, in Europe, which vis-a-vis the American suppliers to the Japanese suppliers, the Europeans are neutral, we have a 55-percent market share in Europe.

Chairman LaFalce. But the Japanese say: "But we demand higher quality in Japan than they do in Europe or the United States." And if they want to use a market where quality is not as important, well, that's irrelevant insofar as Japan is concerned; so it's an inappropriate yardstick.

Mr. Myrick. Mr. Chairman, I would accept that they might say that; I would not accept that it's true. Many of my customers, and some of my customers—I prefer not to mention their names at this point, but, my customers are worldwide customers, and they demand the same quality no matter where I ship the product. So I don't think that it's necessarily a given that just because it's not Japan it has to be of a lesser quality, even to supply the product into the country.

But the other point is that outside of Japan, and outside of the United States, in the rest of the world, in other words, the percentage is 47 percent. That's outside Japan, and the United States, and Europe. The percentage is 47 percent, basically the same as the 55 that we're talking about in Europe. The rest of the world is not materially, I think, on a different quality standard than is Japan.

Chairman LaFalce. Mr. McDonnell and Mr. Myrick especially—Mr. Calder, if you want to come in, too, fine—are you satisfied that this administration, under Mr. Brock and under Mr. Olmer, has been, first, adequately knowledgeable about the barriers that Japan imposes directly and indirectly to our competitive goods and services; and second, sufficiently aggressive in attempting to rectify the situation?

Mr. McDonnell. Mr. Chairman, I don't think that there's any question but that the Department of Commerce and the U.S. Trade Representative's Office both are very, very knowledgeable, very much aware. I think the primary thing that has handicapped them has been the fact that the administration has not taken a strong position of support behind them.

Within the administration, there is a division of opinion as to exactly how strongly we should stand on this particular issue. And, certainly, Treasury and State do not take the same stand that Commerce and USTR take.

If I'm speaking from an industry point of view in having participated with them in negotiations, I'm delighted to have them on our side. I share your concern at watching the first team leave. I'm very concerned about who they bring in out of the bullpen.

Chairman LaFalce. Again, what do you think is going to happen there when all of a sudden we are without Brock and without Olmer? I mean, this is not to cast dispersions on the new team, but what effect do you think it's going to have regardless of the ability of Mr. Yeuter, and Brock's and Olmer's replacements?

Mr. McDonnell. Well, I think we're sending out the wrong signals by that move. I mean, there's nothing that you or I can do about it. Certainly, Lionel Olmer has served long and well and is entitled to a change in career. But I do have trouble in my mind justifying the move of Brock from USTR over to the Labor Department. And, yet, I think it sends out a signal to the Japanese on exactly where the administration at the very top comes down on this trade issue.

Chairman LaFalce. Yes; Mr. Myrick, on the first question about the knowledge and aggressiveness?

Mr. Myrick. I can say that with regard to Mr. Brock and also with the Commerce Department, we were impressed with their dedication to our cause. We were impressed with their desire to learn from us, to gather information from the industry and to use it to the best ability that they had.

In the negotiation in the high-tech work group, I think that their representatives made a genuine effort to improve the situation. I suppose that's the part that's most frustrating to us, in that, in spite of a genuine effort by what we considered to be dedicated public servants, no net result has come from it.

Chairman LaFalce. What I'm concerned about, too, is that the negotiators for the Japanese may have been there for the past 10 to 20 years, or will be there for the next 10 to 20 years, regardless of changes in political personna; whereas, we will have changes not only in our appointed public officials, but within our bureaucracy, within USTR, and within the Commerce Department. I am just wondering what impact that is going to have on what I think, to be successful, will have to be long-term negotiations.

Mr. Calder.

Mr. **Calder**. I couldn't agree more with your general sentiments, Mr. Chairman. I find in discussions that I have in Japan that the Japanese do value this personal dimension very much. They become much more flexible when they can trust the individuals involved and they can make longrun tradeoffs over time.

In other words, they can say: "We'll give you one now; you give us one the next time around."

But if there isn't a next time around, if the person they're dealing with doesn't have the capability to deliver 5 years down the line, or even longer than that, then they become more rigid, more circumspect. It's more difficult for them to deal.

So I would emphatically agree that if we did have people who were in for longer periods of time, if we had more continuity, then we would undoubtedly have much more success in dealing with Japan.

Chairman **LaFalce**. Mr. McMillan.

Mr. **McMillan**. I apologize for being late getting back, Mr. Chairman. I had to go to a hearing on the Small Business Administration where a constituent of mine was testifying on another important matter, and so I'm not totally up on what you've said here this morning.

But I was interested when I came in, Mr. Calder, in your comment that things may be changing in Japan because the issue was moving into the hands of the politicians.

Would you make the same assessment about our own attitude with respect to trading with the Japanese, that perhaps we may make some progress on our side because it seems to be moving back into the hands of the politicians? [Laughter.]

Mr. **Calder**. Well, I certainly agree with you that the concern of Congress, the direct involvement of Congress on these issues, is absolutely crucial in assuring that Japan realizes we are serious, and that it does have to move.

Certainly, the Japanese politicians are pragmatic, as I've mentioned. I should imagine you are that way as well. Flexibility and pragmatism certainly are very important under these circumstances. If the Japanese politicians can be made more internationally conscious, Diet-Congress communication could be important.

I guess the one problem—danger that I would see is the danger of uncertainty concerning how the process as a whole might evolve if it were taken entirely out of the hands of the executive branch. Japan's foreign Ministry and some other countries also have lot of experience on diplomatic trade issues that should be wasted.

I agree emphatically with you that greater congressional involvement on these issues, particularly to stress to Japan the political importance of greater market access, is most important.

Mr. **McMillan**. Well, I think most of us come in here with ideals about trade. Probably, most of us believe strongly in free trade. We also come in here with pragmatic considerations about the effects of our free trade policies, the ill-effects perhaps on some of our own constituents. And I come from an area that has been traditionally a textile area that has suffered tremendously as a result of imports over the past 20 years really. And especially in the last 4 years, it has accelerated dramatically.

That obviously has to motivate my concerns, and I think others come from other parts of the country that are adversely affected by other things.

So I think we, as Members of the Congress, are taking these issues much more seriously. I have the feeling that that concern is going to have an impact on our own toughmindedness in dealing with our trading partners.

I asked Mr. Olmer this question because it's one that's very central to my ideas about free trade inasmuch as I support the idea of free trade, but I think that we have to insist that our trading partners play the game by the same rules that we do. And I think we are dealing here in part with outright restrictions on imports into other countries, but maybe more insiduous are the wide ranges of subsidies, direct or indirect, that impact our worldwide competitors, either affecting their ability to export into our market or to compete with us in their own markets and third country markets.

I would be interested, from your own particular industry standpoint in the degree to which you think those subsidies weaken your competitive position.

Mr. McDonnell. Well, speaking for the telecommunications industry, there's no question that over the last 10 or 15 years, that has had a very significant impact in our ability to compete in Third World markets—not just with the Japanese, I should point out—but also with the European markets as well because they have enjoyed a protected market.

Historically, the indigenous supplier has charged more to the local PTT. The local PTT has provided them with research and development funding and basically they then turn around and use that investment against us, if you will. They don't have to recapture that investment as an American company has to when they compete against us in the Third World markets.

However, I'd also like to point out, at least in the case of our industry, that in spite of those subsidies which I agree are real and which I agree represent a problem, we've done very well against them just as the semiconductor industry has in the Third World countries where they don't have their own local source of supply.

That doesn't mean we're not concerned because we do feel we're not all playing by the same set of rules.

Mr. Myrick. We, of course, see also subsidies around the world, in our industry. I think one aspect of subsidy that is perhaps even more insidious is in some countries of the world, and the one I've been chatting about here today, is the most obvious example. There has been a structural division of effort identifying certain groups of companies to work somewhat collectively on certain areas of a market and thereby preserve their R&D expenditures and actually compounding their R&D expenditures to achieve a better and greater result than would have occurred had 10 companies individually been duplicating the same amount of effort.

Until last year we had, shall we say, some apparent impediment arising out of our antitrust laws for our having done the same thing. Fortunately, last year the Congress for which we are again grateful passed the National Cooperative Research Act of 1984 which is going to aid us but we're somewhat behind in that process of developing this joint R&D activity that has been prevalent throughout the 1970's and certainly into the 1980's in other countries.

Mr. CALDER. If I might just make one brief comment on this question of subsidies. In comparison to Europe, my impression is very definitely that in a range of internationally traded sectors, particularly where big businesses are concerned, that Japanese subsidies in many cases actually may be less than those of the Europeans, although, still in some areas significant and in some areas a major problem for us.

The big point, however, is that there is a sharply different distribution in Europe and in Japan. Support for small business is much greater in Japan. More significant, probably, than in any other part of the industrialized world.

Whether this is good or bad is another question. Whether it's for traded sectors or not is another question. Most of the aid goes to sectors like distribution and so on which are basically nontraded sectors so the trade effects are minimal. Much of the assistance is not financial but comes in such forms as information and marketing assistance.

My point would be that the support for Japanese small business is significant and in certain respects that may be seen even as a positive lesson for the United States.

The Japanese, in other words, feel that small business deserves support and concern from government. In some ways that's true in this country also, but in other ways that's not quite so clear perhaps.

Mr. MCMILLAN. Can I have one more question, Mr. Chairman?

Do you think in addressing this issue, we tend to talk about restrictions and those kinds of corridors or those kinds of restraints on free trade. Do you think that our trade policy should take into account differentials in government subsidy and attempt to quantify them by product area and negotiate in a very tough minded fashion on those differentials?

Mr. MCDONNELL. Well, I think anything that you can do to get us basically equal in terms of competition would be very beneficial overall. We, as an association, have not advocated in the past any protective legislation. You talk about being a free trader, we feel if we can get the entire world on a free trading basis that we'll more than hold our own, and that's why we haven't come out in support of some of the retaliatory legislation that's come before this Congress.

However, at some point in time, where do you draw the line in terms of establishing a tough negotiating position on all of these issues and trying to establish an equal mode of operation on both sides of the trading border?

Mr. MCMILLAN. I would tend to agree with that. I believe in free trade but I think if you're going to be in a position to negotiate to achieve free trade, you've got to have some basis in technique to go about achieving it. I think we've been out paying it lip service and have not, perhaps, provided the tools to our negotiators with which to get to where we want to go and that would be in an open free trade situation.

Well, I thank you very much.

Chairman LAFALCE. Thank you very much.

I didn't want to interrupt, but, unfortunately, I must bring today's hearing to a conclusion. We have benefited greatly from the collective wisdom of all the panelists.

Right now, though, the House is beginning an extremely important debate on the issue of the seating of a Representative for the Eighth Congressional District in Indiana. It's something that I think both Mr. McMillan and I must be in attendance at.

The subcommittee will adjourn. Thank you.

[Whereupon, at 1:47 p.m., the subcommittee adjourned subject to the call of the Chair.]

THE OVERVALUED DOLLAR

TUESDAY, MAY 14, 1985

House of Representatives,
Subcommittee on Economic Stabilization,
Committee on Banking, Finance and Urban Affairs,
Washington, DC.

The subcommittee met, pursuant to notice, at 10:10 a.m. in room 2220, Rayburn House Office Building, Hon. John J. LaFalce (chairman of the subcommittee) presiding.

Present: Chairman LaFalce; Representatives Shumway and McCandless.

Chairman **LaFalce**. The Subcommittee on Economic Stabilization will come to order.

I think today's hearing is going to be especially interesting and especially important because it is going to be on the subject of the overvalued dollar. The overvalued dollar has, in my judgment, been the major contributor to the competitive problems that have confronted American industry.

Yet, if we were judged by the actions of this administration, we would have to conclude that the high dollar presents no problems whatsoever.

President Reagan has just returned from the economic summit in Bonn. At the summit, he once again refused to commit his administration to negotiations regarding current exchange rate misalignments, maintaining there is no need to link this issue to trade talks.

Yet no efforts at resolving our competitive difficulties can possibly work unless, and until, we have success in dealing with the overvalued dollar.

The President's failure to acknowledge the link between the monetary and trade imbalances we are experiencing has not jeopardized the initiation of badly needed trade negotiations.

The dollar is now as much as 50-percent overvalued when measured against other major currencies and continues to exacerbate our increasingly uncompetitive trade position. Its effects are being felt throughout American industry.

The uncompetitive dollar makes foreign imports less expensive and U.S. goods more costly when exported abroad. As a result, the U.S. exports have been flat while imports have been soaring.

Last year the U.S. ran up a trade deficit of $123.3 billion, and experts estimate that the overvalued dollar accounts for 50 percent or more of that deficit.

The dollar is pushing our domestic industries into increased outsourcing and movement of the production facilities abroad. In 1984 one-half of every dollar spent on capital equipment went for overseas purchases. On an all-industry basis, the strong U.S. dollar and related problems have cost the country over 2 million jobs. That number will grow unless something is done and done quickly.

I do not subscribe to the Pollyanna view that the high dollar brings benefits which outweigh its serious negative impact on U.S. trade. It may be true that by making imports cheaper, the high value of the dollar has helped hold down inflation during the recent economic expansion.

But recordbreaking levels of imports and high domestic interest rates, while they may keep inflation under control, are transforming the economic structure of this country.

The slowing of growth over the last three quarters has brought about greater recognition of the widespread and permanent damage that has been done to U.S. industry. It is in our most competitive capital equipment and high-technology industries that we have seen the greatest erosion of our competitiveness.

As recently as 1981, the United States had a surplus of manufactured goods trade. Our position has deteriorated dramatically. In contrast with the U.S. manufactured goods deficit of $90 billion last year, Japan had a global surplus of over $120 billion, and Germany of $60 billion.

In high technology products our trade surplus fell from a high of $29 billion in 1981 to about $9 billion last year.

The high dollar has also created serious resentment abroad from both industrialized and Third World debtor nations. By attracting large quantities of foreign investment into the country to finance the U.S. budget deficit, the United States has depleted the investment resources of U.S. allies in developing countries.

The overvaluation of the dollar has persisted despite U.S. trade and current account deficits on an unprecedented scale and many predictions of a rapid fall in recent years—and despite the fact that the basic premise of the floating exchange rate system is that large current account deficits will lead to an automatic and self-correcting fall in the value of a country's currency.

The causes of the dollar's gross overvaluation are complex, but a major element is the high real interest rates engendered by growing Federal deficits that this administration is making little progress in reducing.

The dollar's underlying character is one of instability. A sudden fall in its value could unhinge both the United States and world economies.

It is becoming more and more difficult to argue that the present international monetary system, or nonsystem, is providing a stable basis for world trade and investment. In the last 12 years, key currencies like the dollar, pound and yen have gone up or down by 30 to 50 percent within a couple of years. This plays havoc with all traded goods and service industries.

We have been drifting while our industries slowly collapse. I personally refuse to believe that this is the only course open to us. It should be possible to avoid the egregiously misaligned currency values of the past few years with their enormous economic distortions and impetus to protectionism.

Certainly, there are no simple solutions to bringing currencies into better alignment and stabilize them there. But there are no simple solutions to any of our trade problems.

A variety of policy proposals for dealing with exchange rate misalignments have been advanced, and it is long past time for this administration to stop ignoring the problem and examine them closely. We must take the steps necessary to extract ourselves from the precarious situation the overvalued dollar creates.

This morning, in order to discuss this issue with us, we are very pleased to have an unusually distinguished panel. We have with us today former U.S. Congressman, chairman of the House of Representatives Banking Committee, chairman of the Joint Economic Committee, Henry S. Reuss; Manuel Johnson, Assistant Secretary of the Treasury for Economic Policy; Paul L. Smith, senior vice president and director of finance administration for Eastman Kodak Co., headquartered in the 32d Congressional District of New York State that I have the privilege of representing; Prof. Ronald I. McKinnon of Stanford University; and Scott Pardee, executive vice president of the Discount Corp. of America.

Gentlemen, we will put the entire text of your remarks in the record, and we ask each of you to summarize you remarks. Since there are five of you, we would ask you to try to summarize them within a maximum of 10 minutes or so and then we can engage in a dialog.

Before we begin, however, I want to call upon the distinguished ranking minority member of this subcommittee, Representative Norman Shumway of California.

Mr. SHUMWAY. Thank you, Mr. Chairman.

I would like to join with you in welcoming this distinguished panel of witnesses before the subcommittee this morning, particularly our former chairman, Congressman Reuss. It is nice to see you again and nice to have you here in this subcommittee.

In the economic arena today the U.S. dollar is on a meteoric rise. Indeed, for the last 5 years the dollar nas been rising at an average rate of 11.5 percent against the currencies of major industrial countries.

This development has gone hand in hand with an enormous inflow of foreign capital and an ever deteriorating U.S. foreign trade position. Merchandise imports are now exceeding exports by $131 billion while our deficit on current accounts has reached an unprecedented $132 billion.

Needless to say, the recordbreaking course, together with the widening trade deficit is rapidly transforming the United States into an international debtor. More importantly, it has left its mark on U.S. industrial growth and competitiveness in terms of rising imports, falling exports, lower prices, anemic profits, insufficient technical development, job exports and exits from traditional manufacturing activities.

Despite this horror story and its gloomy ending, we must ask ourselves several very important questions. Will the strong dollar transform the United States into the next Brazil or Argentina? Is it the epitaph on the grave of free and fair trade or the transmission mechanism between the U.S. engine or growth and the economies of the international debtors?

I don't believe we are about to become the next Brazil or Argentina. There is nothing irrational or wrong with the market's preference for the dollar. In fact, this preference is largely based on economic fundamentals and its benefits should not be overlooked.

From the market standpoint the United States has enjoyed a sustained recovery, improved productivity, reduced unemployment and low inflation, along with a politically stable environment.

The basic strength and promise of the U.S. economy compared with other potential investment environments is a fundamental source of the dollar's strength. The exchange rate reflects this positive attitude.

The strong dollar has achieved a cause celebre status in the large trade and account deficits and industry's inability to compete abroad. Yet it shares that role with that of lagging economic performances in European countries, the financial problems of Latin America and the increasing competitiveness of the newly industrialized countries.

As far as American industry is concerned, the strong dollar has forced efforts to modernize and improve productivity that could not be postponed for long without disastrous consequences.

Finally, it has provided the power for the U.S. trade locomotive, which in turn has boosted the output in the rest of the world significantly since 1981.

Instead of decrying the situation, we should ask the more appropriate question of whether the dollar's strength has gone too far. In terms of purchasing power parity it probably has.

Beyond that, however, we must look to the real reason underlying its strength. We are a country with a low propensity to save. We have decided to run a large budget deficit whose insatiable debt needs feed on itself. Failure to rein in this monster will only create an unstable volatile environment for investors whose willingness to invest in America may subside at precipitous rates.

If this happens, we will be forced to face a more forbidding scenario of a sharp depreciation of the dollar, the reigniting of inflation and reappearance of another round of recession.

Mr. Chairman, we cannot allow this to happen to our economic recovery, and I hope that this panel of witnesses will provide us some insight and perhaps some answers to this dilemma as we pursue this subject today.

Thank you.

Chairman LAFALCE. Thank you very much, Mr. Shumway.

Our first witness is the former U.S. Congressman Henry S. Reuss.

STATEMENT OF HON. HENRY S. REUSS, FORMER CHAIRMAN, HOUSE COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS, AND THE JOINT ECONOMIC COMMITTEE, U.S. CONGRESS

Mr. REUSS. Thank you, Mr. Chairman, Mr. Shumway, and my colleagues on the panel. I am delighted to be back here and take part in the inquiry of the Subcommittee on Economic Stabilization into the uneconomic destabilization being caused by the overvalued dollar.

Chairman LaFalce. Before you go any further, too, I forgot to thank you, Henry, because the first thing you did when you became chairman of the Banking Committee in 1975 was to create a Subcommittee on Economic Stabilization, and if it weren't for you, I wouldn't have a job. [Laughter.]

Mr. Reuss. So the least you could do is invite me back. Thank you, Mr. Chairman.

I was very impressed by the opening statement of both you and Mr. Shumway, which really sets the stage for what I know will be an interesting panel.

I will start right out by going to scriptures and paraphrasing Ecclesiastes, the dollar also riseth, and the dollar goeth down; and there is no new thing under the sun.

What I am going to try to do in my 10 minutes is to see whether there may not be an example or two from the past of when the dollar was overvalued, and then, by looking at what was done about that, we may have some guidance about what to do and what not to do in the troubled days that lie ahead, for there will be troubled days by allowing our budget to careen out of control. We have let our interest rates rise unduly and with them our foreign trade deficits, our capital inflows, and the international dollar.

Even if this subcommittee could wave a magic wand and cause the dollar to make a nice, soft downward landing, our misguided economic policies over the last 2 years would still exact their permanent penalty.

Some of our finest export and import competitive industries have lost their markets so thoroughly that they are likely never to recover.

Over in Europe and Japan some of their hyped up export industries, hyped up by a free ride on our inflated appetite for imports, are going to bring imbalance to their economies long after equilibrium has been restored.

Meanwhile, the seeds of protectionism here in the United States and mercantilism abroad will continue to germinate.

The less developed countries, in my view, are never going to be able to finance all the debts incurred at very high dollar costs and at high interest rates to their own damage and to the peril of the world banking system. In the end the American people are going to experience an impairment of what would otherwise be their standard of living as a result of our shift, and a drastic one, from creditor to debtor nation status.

We can't do anything about these long-term consequences. They are already written in the stars. But we can and must do some things to stop further damage, and I am going to suggest four not very original things that I believe we need to do.

No. 1, bring the budget under control fast. I am very pleased at the results obtained in the other body within the last few days, and I am quite optimistic that when we are through with the budget resolution, as we will be in a few days, the House and Senate, Democrats and Republicans, will agree on spending cuts somewhere in the $50 billion area for fiscal 1986 attained by the Senate, maybe freezing everything in place in real terms with such exceptions up or down as are dictated as the best that can be accomplished, and that in essence is the way both bodies seem to be going.

But the point I want to make is that on top of these spending cuts, it is not enough and we are going to need more tax revenues. Reducing the 1986 deficit from $200 billion, and these are rounded figures, to around $150 billion is simply not enough. So we need more tax revenues.

Well, how are we going to get them, and how can the Congress in good conscience raise additional revenues while the income tax base remains the inequitable horror that it is? Yet here it is May and we still don't have the administration's tax reform bill 6 months after the U.S. Treasury's historic November 1984 study. At the rate we are going with the bills in the mail coming at us every week, we are never going to get the budget under control.

What to do? Well, one suggestion I would make is why not take the November 1984 Treasury plan, and it is a pleasure, Secretary Johnson, for me to pay tribute to that, enact it now effective January 1, 1987, and then give the loophole lobbies a chance one by one to overturn whatever parts of it the Congress will vote to overturn. That would show great seriousness.

Having done that, having enacted the revenue-neutral Treasury plan, and I might add that I don't believe that President Reagan would fail to sign his Treasury's own proposal, Congress should promptly enact whatever modest surcharge on that reformed income tax structure, also effective January 1, 1987, is needed to bring the budget deficit under control. That would not have to be a very steep surcharge and such are the salubrious effects of getting the budget under control that I would venture to say that the surcharge could be phased out very speedily.

Would the President sign the surcharge? Well, even if he vetoed it, the Congress would have demonstrated to the world that it had the gumption to come to grips with the deficit, and the international dollar would be better for it.

Second, with the deficit under control, ease monetary policy. It is quite likely to ease all by itself with this pressure taken off of it. In fact, the Federal Reserve is now seemingly doing a bit of easing on its own fearful of the safety of the U.S. financial system, and with one eye on Ohio and the other on Maryland, it is doing what it can to bring these many crises under control. So ease by the Federal Reserve is clearly indicated once you get the deficit under control.

Third, let the dollar gently shed its overvaluation. The dollar went up without asking anybody's permission and it will go down likewise. Ill-considered efforts by the White House of the Federal Reserve to slow the dollar's downward course should not be undertaken. What is needed is growth at home because after all when you reduce the fiscal stimulus by getting the budget under control, you have to provide it in some other way, and that other way is by lower interest rates.

What is needed is growth at home to be obtained from those lower interest rates and from the improved export-import performance of America's now beleaguered industries. So measures such as hiking up interest rates to attract foreign capital and measures such as extensive foreign exchange intervention to slow the dollar's decline not only probably wouldn't work but, if they did, would entail serious real costs in growth.

Fourth and last, shingle the roof on the barn before it rains. Prepare measures now to counter the one-shot inflationary impulse which would come about by a declining dollar.

As all agree, one plus of the overvalued dollar is that it does help us out on inflation by giving us bargain basement prices on all our imports. If that were all there were to the matter, we would all be for an ever rising dollar, but of course it isn't. But that means that nonetheless, you have got to do what you can to protect against the one-time inflationary impulse that you get from a decline in the dollar. And there I think that we have to put into effect measures like what we should have had in effect to combat the oil price increase of the late 1970's, and because we didn't, we suffered.

Particularly we need to keep our strategic petroleum reserves filled and we need other strategic commodities stores readied to moderate any upward price trends in materials. We need to get rid of the protectionist barriers which are beginning to creep into our system, and we need some sort of a national policy to prevent the import price upward creep from being reflected in wage increases which are out of line with productivity increases.

One thing the Federal Government could do, and it is a long way short of any formal wage, price or incomes policy, is to get together a concerted policy on what it is going to do about cost-of-living increases in pensions, in social security and in taxes, and then perhaps make something like that a standard for wage bargaining. In earlier times the Banking Committee has been out in front on such remedies.

Now back finally to Ecclesiastes and "there is nothing new under the sun." Fifteen years ago in 1971, as today, the dollar was painfully overvalued, the domestic economy was stagnating and disturbing signs of inflation, at least disturbing to Arthur Burns, 3-percent inflation, were beginning to appear.

This committee took the lead in pointing out that the dollar's overvaluation needed to be cured, and that some sort of a wage, price incomes weapon needed to be in the arsenal in order to help contain inflation while easier money restored growth.

So the Banking Committee made studies, uttered reports and enacted legislation toward these ends. The Nixon administration was not many of us thought sufficiently grateful for these efforts to be helpful by the Banking Committee. In fact, our efforts were stonewalled.

I well remember on May 28, 1971, when Treasury Secretary Connally told the ABA in Munich we are not going to devalue, we are not going to change the price of gold, and then a few days later after conferring at Camp David with President Nixon, he added no wage and price controls.

So it was a pleasant surprise on Sunday, August 15, 1971, when President Nixon announced his new economic program lowering the dollar's value by closing the gold window and countering possible resulting inflation by imposing wage price controls.

The results in economic growth, in jobs, in price stability and in world respect were sufficient to ensure Mr. Nixon a triumphant reelection only 14 months later.

Now 1971 is not 1985. The situations are different. But at least the lesson from the past, which strikes me, is that the Banking Committee once again should be out in front on what needs to be done in the present circumstances.

Congress wasn't thanked by the administration in 1971 for having prepared the way, and Congress, I am afraid, isn't going to be thanked by the present administration for preparing the way for a gentle dollar decline by cauterizing the wounds of the resulting inflation. But thanks or no thanks from the White House, the Congress would have deserved well of the Republic.

I appreciate this opportunity to share my thoughts with you, Mr. Chairman.

[The prepared statement of Hon. Henry S. Reuss follows:]

Statement of Henry S. Reuss before the House Banking Committee's Subcommittee on Economic Stabilization, 2220 Rayburn H.O.B., Tuesday morning, May 14, 1985

As an alumnus of this Committee, I'm honored to take part in the inquiry of the Subcommittee on Economic Stabilization into the Uneconomic Destabilization caused by our over-valued dollar.

To paraphrase Ecclesiastes, the dollar riseth, and the dollar goeth down; and there is no new thing under the sun. My sermon today is that there are examples in the past of a dollar that was over-valued, and that these examples may help guide us in the troubled days that lie ahead.

For make no mistake: the days ahead will be troubled. By allowing our budget to careen out of control, we have allowed our interest rates to rise unduly, and with them our foreign trade deficits, our capital inflows, and the international dollar.

Even if this Subcommittee could wave its magic wand and cause the dollarto make a soft landing downward to its true level, our misguided economic policies of the last few years would still exact their permanent penalty. Some of our finest export and import-competitive industries have lost their markets so thoroughly they are likely never to recover. The hyped-up export industries of Europe and Japan, with a free ride on our inflated appetite for imports, will bring imbalance to their economies long after the dollar's over-valuation has been righted.

Meanwhile, the seeds of protectionism here and mercantilism abroad will continue to germinate.

The less developed countries will never be able to finance the debts incurred at high dollar costs and at high interest rates, to their own damage and to the damage of the world banking system. And the American people will experience an impairment of their standard of living as a result of our shift from creditor to debtor nation status.

These long-term consequences of our over-valued dollar are aleady written in the stars, beyond our power to change. But we can and must stop further damage. This we can do by changing our wrong-headed economics before it is too late. For instance:

1.Bring the budget under control, fast. Rather than spend the next year in partisan wrangling about spending cuts, let the House and Senate, Democrats and Republicans, agree now on what to do about spending. Perhaps to freeze everything in place in real terms, with such exceptions up or down as are dictated, is the best that can be accomplished.

On top of these spending cuts, more tax revenues will be needed. But how can Congress in good conscience raise additional revenues while the income tax base remains the horror that it is? Yet here it is May, and the Administration has still not sent up to the Hill its tax reform bill, six months after the Treasury's historic study. At the rate we are going, we will never get the budget under control.

What to do? Well, why not take the November, 1984, Treasury Plan, and enact it now, without cripping amendment, but with its effective date delayed by one year, until January 1, 1987? That would give the loophole lobbies 4, ✓ 18 months the opportunity to convince Congress that changes in the Plan , one by one, should be made.

Having enacted the Treasury Plan--Mr. Reagan could hardly refuse to sign his Treasury's own proposal--Congress should then promptly enact a surcharge on the Treasury Plan, also effective January 1, 1987, in the amount and for as long only as needed, sufficient to bring the deficit down to a sustainable relationship to Gross National Product. Would the President sign the surcharge? Even if he vetoes it, the Congress will have demonstrated to the world it has the gumption to come to grips with the deficit. The international dollar will be the better for it.

2. The deficit under control, ease monetary policy. Unless monetary policy is eased, curtailing the present deficits would depress economic growth and even risk a recession. A modest easing of Federal Reserve monetary policy is needed to stimulate housing, capital investment, and new business formation. As a matter of fact, the Fed is now undertaking such an easing for an imperative reason of its own--the safety of the U.S. financial

system. The Fed understandably feels that it cannot afford a string of mini-crises as with the Ohio savings and loans, and as may be brewing in oil and farming.

3. *Let the dollar gently shed its over-valuation.* The dollar went up without asking permission, and it will go down likewise. Ill-considered White House or Fed efforts to slow the dollar's slide should be abandoned. What is need is growth at home, to be obtained from the lower interest rates discussed above, and from the improved import-export performance to be expected from a less over-valued dollar. Measures such as foreign exchange intervention to slow the dollar's decline would probably be futile, and would entail serious real costs in growth if they were successful.

4. *Prepare measures to counter the one-shot inflation engendred by a declining dollar.* The U.S. is currently suffering not only from a stagnating growth rate but from some signs of rekindled inflation--a 5 percent current inflation rate and greatly curtailed productivity growth. There's no doubt about it, a declining dollar will increase our import costs and thus raise inflation.

So we should now be giving thought to how to cushion that inevitable first-round import price shock. Measures other than super-tight money must be put in place if we are to avoid the crippling 20 percent interest rates of the 1980 and 1981 variety.

The Strategic Petroleum Reserve and other commodity stores should be readied to moderate any upward price trends in materials. Protectionist barriers that aggravate import costs should come down. And the inflationary pass-through of higher import prices into domestic wages and other costs must be stemmed. As in earlier times, the creativity of the Congressional Banking Committees is needed.

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Now back to Ecclesiastes and "there is nothing new under the sun." Fifteen years ago, as today, the dollar was painfully over-valued, the domestic economy was stagnating, and disturbing signs of inflation were beginning to appear. This Committee took the lead in pointing out that the dollar's over-valuation needed to be cured, and that a wage-price-incomes weapon needed to be in place to help contain inflation while easier money restored growth. Studies were undertaken, reports were made, and legislation enacted toward these ends.

The Nixon Administration, you will recall, stone-walled these Congressional efforts to be helpful. On May 28, 1971, Treasury Secretary John B. Connally told the American Bankers Association at Munich, "We are not going to devalue. We are not going to change the price of gold." A few days later, after conferring with President Nixon at Camp David, Secretary Connally proclaimed "No wage and price controls!"

Then, on Sunday, August 15, 1971, President Nixon astounded the world with his New Economic Program, lowering the dollar's value by closing the gold window, and countering possible resulting inflation by imposing wage-price controls. The results in economic growth, jobs, price stability, and world respect were sufficient to ensure Mr. Nixon a triumphant re-election 14 months later.

Congress was not thanked by the Nixon Administration for having prepared the way for the two bold actions of August 15. Congress, I'm afraid, would receive no thanks from the Reagan Administration for having prepared the way for a gentle dollar decline by cauterizing the wounds of the resulting inflation. But thanks or no thanks from the White House, the Congress would have deserved well of the Republic.

Chairman LaFalce. Thank you very much for that excellent homily. I think you give Congress too much credit for the reelection of President Reagan.

Mr. Reuss. We did our part.

Chairman LaFalce. I think George McGovern did his part more than anybody else. Of course, he was a Member of Congress.

Our counterpoint perhaps will come from the Treasury Department, Assistant Secretary of the Treasury for Economic Policy, Mr. Manuel H. Johnson.

STATEMENT OF HON. MANUEL H. JOHNSON, ASSISTANT SECRETARY FOR ECONOMIC POLICY, DEPARTMENT OF THE TREASURY

Mr. Johnson. Thank you, Mr. Chairman and Mr. Shumway.

Well, first, I think I would like to point out in the brief summary period that the dollar is of course strong, as we all know, but it is really strong relative to the 1970's. It is not substantially out of line with the dollar value in the 1960's when inflation was low and we had prolonged periods of strong real economic growth.

So I guess the level of the dollar and whether the dollar is strong or not is a relative concept. It depends on what you are comparing it to, and I guess compared to 1979 or early 1980 and a large part of the 1970's we do have a strong dollar relative to the 1960's and other periods——

Chairman LaFalce. Well, rather than compare the dollar today to the dollar of the 1970's or the 1960's, let's simply compare the dollar of today to the Canadian dollar of today, the yen of today, the mark of today, the franc of today in order to not waste time on semantics—to determine whether or not the administration does or does not believe that the dollar today, vis-a-vis other world currencies today, is overvalued.

Mr. Johnson. Well, I think that the problem that you have with that is that there is no way to know exactly what the right level of the dollar——

Chairman LaFalce. So the position of the administration is that we do not know whether we have an overvalued dollar or not; is that correct?

Mr. Johnson. Yes, I think that is generally right.

Chairman LaFalce. Please proceed.

Mr. Johnson. Now the dollar is definitely strong relative to some base period that you might want to compare it to like 1980 or the decade of the 1970's, and it has certainly gained strength relative to other foreign currencies. There is no doubt about that.

But you have to look at the reasons for the strong dollar to determine whether they are bad or good, and obviously there are pros and cons associated with a strong and weak dollar.

First, I think it is important to understand the reasons for the dollar's strength, and that is that there has been a tremendous surge in capital inflow to the United States, and I think we have to understand the sources of that surge in capital inflow to the United States.

Usually when people talk about this fact they naturally assume that the United States has somehow absorbed or sucked foreign capital away from other countries. But in fact if you looked very carefully at the capital account data, you recognize that nine-tenths of the source of net foreign capital inflow into the United States has resulted from a shift in U.S. lending abroad, and the fact that U.S. financial institutions are no longer lending abroad to the extent that they were. They are now investing domestically as opposed to having capital flow out of the country.

So this transition of capital flows has produced the strong dollar. It is simply the retention of capital in the United States rather than exporting it abroad and that is the major source of the strong dollar.

Now you have to ask yourself well, is this surge in net capital inflows something that has been forced upon the United States or has this been a voluntary flow of capital. And I think if you look carefully at the evidence you will find out that nobody forced this capital into the United States. It voluntarily found its way in and they are indicating that there was a very strong demand to hold dollar denominated assets, financial assets, real assets and assets of this type. So there has been an excess demand for dollars and this has produced the strong dollar.

Now why do people want to hold these dollar assets? Well, there are several things that have happened, I think, over the last several years that have improved the willingness to hold dollars and has created an excess demand for dollar denominated assets.

The first of those I think is that we have put in place a set of tax laws in this administration that indeed raised the after-tax real return to capital investment. So that in a relative sense it is more attractive to invest in the United States than other countries relative to the past, and at the same time the inflation rate has come down substantially. So that the combination of improved after-tax returns to capital and the fact that inflation is substantially lower especially relative to other countries has dramatically improved this demand for dollars or willingness to hold dollar denominated assets in the United States.

Chairman LAFALCE. Of the rise in the dollar, how much happened in 1981 or 1982?

Mr. JOHNSON. I think you had about 15 percent a year in 1981 and 1982, and a similar amount I guess, or maybe about 10 or 11 percent in 1983, another surge in 1984, and then I think it is has been about flat since the beginning of this year. There has been some easing off.

Chairman LAFALCE. Most of the increase in the dollar was during the recession that was going on.

Mr. JOHNSON. That is true, a lot of it was during the latter part of 1981 and 1982. Of course, the argument there is, and once again when you look at the dollar you have to look at it in comparison and in a relative sense. And it is also true that Europe was also in a recession. It is also true that at that same time Third World countries had gigantic international debt problems.

Of course, this helps explain part of the willingness to hold dollar assets is the fact that the riskiness of investing in developing countries increased substantially during this period and the international debt crisis, I think, caused a lot of U.S. foreign lending to pull back. And of course rather than invest in Europe, which was also relatively in bad shape, it was determined that the United States had the best after-tax returns to capital with the relatively lower inflation rate and therefore was a good place to invest financial assets.

So I think that this accounts for a large part of the dollar strength. The higher returns to capital, the relatively lower inflation rates and the relatively higher risk abroad that existed and still exists at this time have led to this net inflow of capital. I think that that is the primary reason for it, and so market forces have basically I think led to this fact.

Now it is true that we do have a large budget deficit primarily resulting from our inability to control the rate of growth of Federal spending. Once again——

Chairman LaFalce. What is the percentage of Federal spending now as a percentage of GNP?

Mr. Johnson. It is about 24 percent.

Chairman LaFalce. A 23-plus percent.

Mr. Johnson. Yes, between 23 and 24.

Chairman LaFalce. In 1980 was it about 23-plus percent?

Mr. Johnson. In 1980 I believe it was a little bit lower than that.

Chairman LaFalce. It was around 23-plus percent in 1980. Were the revenues in 1980 about 21.5 percent?

Mr. Johnson. I think that is right.

Chairman LaFalce. And are about 18.5 percent now?

Mr. Johnson. Well, between 18.5 and 19.

Chairman LaFalce. All right. People might, therefore, conclude that it was the drop in revenues.

Mr. Johnson. Well, if you looked at 1980 as a comparison, you might conclude something like that, but if you really look at the historical record, you will find that over the whole period from 19——

Chairman LaFalce. We are talking about what the deficit was at one point in time, 1980, and it was a small percentage of GNP.

Mr. Johnson. That is right, and of course——

Chairman LaFalce. And the overall aggregate spending has not gone up appreciably at all. It has gone up three-tenths of 1 percent, about 23.5 or 23.8. It is your revenues that have decreased by almost 3 percent of GNP in that period of time.

Mr. Johnson. Revenues have decreased from a peak period like 1980 when inflation was running at double digit rates and there was a tremendous amount of inflation that was driving incomes into higher tax brackets. Naturally more revenue resulted from that process, but it was sort of a secret continuing unenacted tax increase that was raising revenue at a dramatic pace.

We wanted to step back from that because we saw that that was what was destroying our productivity growth rate. So certainly we felt that it was very important to return receipts back to their historical level around the 18 and 19 percent level. That is where they are now and that is I think certainly——

Chairman LaFalce. Let's get your premises correct. Wasn't the premise of the 1981 tax bill that tax cuts would increase revenues and, therefore, they would be self-sustaining. There was no anticipation that you were going to decrease revenues as a percentage of GNP at all. The promise of Reaganomics was exactly the opposite.

The promise of Reaganomics was that cuts in taxes would increase revenues and not decrease revenues.

Mr. JOHNSON. That was never a premise in the administration. We offered a budget in 1981——

Chairman LAFALCE. Let's just say it was the premise of the most articulate spokesman for the so-called supply-side economics.

Mr. JOHNSON. Well, first of all, you have to remember that the reduction in revenues as a percentage of GNP, a lot that had to do with that was the recession in 1981 and carrying over into 1982 and the sharp drop in inflation. When you are no longer inflating incomes in the higher tax brackets, naturally you are going to have some effect on revenues as a percentage of GNP.

At the same time, when you are trying to reduce tax rates and hold down the bracket creep resulting from inflation, you are going to level revenues off as a percent of GNP. But when you have people being laid off because of a major recession and declining income you lose revenue.

Chairman LAFALCE. Bracket indexation becomes effective this year, correct?

Mr. JOHNSON. That was effective as of January 1 this year, that is correct. But the fact of the matter is that revenues are still at very high levels. They certainly haven't been cut down below historical levels. As a matter of fact, they are only low relative to their previous peak period and not relative to the historical period from 1940 all the way up to the mid-seventies. As a matter of fact, they are still well above that. They will be close to 19 percent or at the level of 19.5 percent by 1990 and this will be back close to historic high levels.

So it is not the fact that we are undertaxing people that is the problem. It is in fact the case that spending has ratcheted up as a percent of GNP. It hasn't gone up substantially since the 1980 period, but if you will trace the growth in spending as a percent of GNP back through the 1970's and into the early 1980's, you will find that it has ratcheted up significantly from about 21 or 22 percent of GNP. So we do have a serious spending problem, and of course every day that we fail to reduce the rate of spending growth, interest payments on the debt——

Chairman LAFALCE. One of the problems is that GNP hasn't gone up that much and that has the effect of increasing the expenditures and decreasing the revenues, correct?

Mr. JOHNSON. Well, certainly I don't want to discourage any real growth that we might have. Certainly we could use all the growth we can get. I think that growth alone is not going to solve our deficit problems.

Chairman LAFALCE. But isn't it true that an increase in GNP is going to have the effect of increasing revenues, and if you don't have adequate increase in GNP, it will automatically increase your expenditures?

Mr. JOHNSON. Absolutely. But the point is that we do have a spending problem, and once again, as Congressman Reuss mentioned, I wanted to say that I think that the administration is encouraged by actions in the Senate and what appears to be underway in the House as a means of coming to grips with the debt spending problem.

Chairman LAFALCE. Don't the actions in the Senate directly contradict two areas that President Reagan said were absolutely sacrosanct? First, he said there would have to be real increases in the Defense budget and they gave a cost-of-living increase, and he said there could be no real reductions in Social Security. There is a real reduction in Social Security in the Senate action.

Wisdom is one thing, but the only question is doesn't that contradict what the President said would be unacceptable?

Mr. JOHNSON. Well, once again, the current package is not our ideal in terms of the way of reducing spending and dealing with the deficit, but I think we have seen over the years that the President is willing to show leadership and accept compromise in order to put together a bipartisan agreement on a major issue of importance.

So I think it is not the best way for deficit reduction and spending restraint is not our ideal type of proposal, but it is something that I think we are willing to live with to deal with a serious problem. So I think in that spirit we are willing to accept a package that we don't agree with in terms of every line item in it.

But once again, I think in terms of the dollar's strength that, in fact, helping reduce the rate of growth of Federal spending along the lines that we are pursuing in the Congress will possibly make a contribution to putting the dollar on a sounder course.

However, I think it is important to point out that if we are able to deal with our budget deficit in a major way by reducing the rate of growth of Federal spending, that this is not a guarantee that the dollar is going to ease.

In fact, as I mentioned, the major source of the dollar's strength is this demand for dollars for investment in the United States. Simply eliminating a major risk to economic stabilization in the long term in the United States is not going to discourage people from investing in the United States. In fact, it could quite easily be more encouraging to investment.

Chairman LAFALCE. You might get a stronger dollar by reducing the deficit.

Mr. JOHNSON. Well, in the short term it may be quite possible to get a stronger dollar temporarily. In the long run you would expect an easing of the dollar to a more stable equilibrium as other countries come into line in terms of their growth rates and the United States is put on a sound footing on a permanent stable basis. But I don't think that dealing with the budget deficit is any panacea for the dollar.

As I mentioned before, the major sources I think of the strength have been the attractiveness of the United States as an investment source. At the same time, we have had lagging growth rates in Europe, and I think that as these European growth rates come more and more into line with those of the United States that we will see some leveling off.

Possibly another source I think of the strength of the dollar, which could be an artificial aspect of the dollar's strength, are periods of monetary tightness. A good example of that might be the period from June 1984 into October when we had zero money growth for a fairly prolonged period. And when you have a large demand for dollars and the supply is restricted to grow at a zero pace, naturally you are going to get some upward pressure on the dollar.

We have seen since the Federal Reserve has eased monetary policies at the beginning of the year that the dollar has eased off of its high levels that it experienced up until that point. As a matter of fact, we have seen a reduction I think in the dollar of over 5 percent since the beginning of the year from its peak levels that partially had resulted from a fairly tight monetary policy that existed for about a 6- to 7-month period in 1984. So certainly excessive monetary tightness also plays a role.

Chairman **LaFalce**. And part to Home State Bank of Ohio.

Mr. **Johnson**. Yes. So I think to avoid taking up too much time on this, I think, first, you really have to look at the sources of the dollar's strength, and I think the sources of its strength are a fundamental restoration of economic strength and the attractiveness of U.S. investments, the lower inflation rate and the higher risk of investing abroad.

And I think that in the short term there really isn't anything that we can do that would not be damaging other than making sure that we don't have excessiveness in our monetary policy, and helping reduce the budget deficit by reducing the rate of growth in spending and assisting our foreign trading partners in getting their growth rates more in line with the United States.

Thank you.

[The prepared statement of the Honorable Manuel H. Johnson follows:]

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STATEMENT OF
THE HONORABLE MANUEL H. JOHNSON
ASSISTANT SECRETARY OF THE TREASURY FOR ECONOMIC POLICY
BEFORE THE
HOUSE SUBCOMMITTEE ON ECONOMIC STABILIZATION
OF THE
COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS

Mr. Chairman and Members of the Subcommittee:

It is a pleasure to be with you today to discuss the causes of the continuing strength of the dollar in foreign exchange markets and the implications of this strength for the U.S. and the international economy.

Introduction

The dollar is off about 5 percent on a trade-weighted basis from its highs in late February of this year but it has appreciated significantly in the last few years. Since 1980, the value of the dollar in foreign exchange markets has risen by about 50 percent, depending on the other currencies included in the comparison and the weights assigned to them. The dollar exchange rate is a crucially important relative price reflecting the balance of supply and demand for the world's leading currency. It is understandable that a substantial exchange rate appreciation could have major economic effects and, therefore, arouse considerable criticism from those who are adversely affected. There has been intermittent criticism from our trading partners about the strength of the dollar and the problems that they feel this poses for them. There is also growing domestic concern that the strength of dollar is imposing costs in addition to the benefits by impacting negatively on U.S. manufacturing and agriculture. Unfortunately, many of the policy proposals calling for U.S. action to weaken the dollar or to shelter the domestic economy from foreign competition would do more harm than good. There are no instant remedies for the problems associated with a strong dollar without creating a cure worse than the disease.

The Historical Background

There have been several distinct phases in the exchange rate experience of the U.S. dollar in the postwar period. Under the Bretton Woods fixed exchange rate regime, there was a period of relative stability until the late 1960's and early 1970's. A deteriorating U.S. balance of payments position then led to two devaluations of the dollar in the early 1970's and a further depreciation of the dollar. The dollar recovered some ground by the mid-1970's but again depreciated sharply later as U.S. inflation ran out of control. These successive phases are clearly apparent in Chart 1 which shows the trade weighted value of the dollar quarterly since 1958.

Assertions that the dollar is "overvalued" are obviously referring to the upward movement since 1980 and implicitly view the level at that time as a desirable one. Although the dollar is strong relative to its level in 1980, it is not greatly different in value on a trade weighted basis from the levels of the mid-1960's before inflation picked up speed. Domestic economic policy had reached a low water mark by 1980 with double-digit inflation and record interest rates. In view of the speed at which its domestic value was disappearing, it is no wonder the dollar was weak in the foreign exchange markets. It is rather paradoxical that some are now arguing that we should adapt our economic policies so as to recreate the conditions of the late 1970's. Such a movement is unlikely to develop much support.

The very concept of the dollar being "weak" or "strong" is elusive at best. Relative to what? Some observers point to the fact that while gold is currently trading a little over $300 an ounce, down from nearly $850 an ounce in January, 1980, it held -- or perhaps more properly was held -- near $35 an ounce during most of the first two postwar decades. (The London price of gold rose to $40 an ounce in 1960 but the price was then held close to $35 until the breakup of the London Gold Pool in 1968.) Statements that the dollar is "weak" or "strong" mean very little unless it is made clear what the standard of reference is -- a weighted average of other currencies or some external standard such as gold or a bundle of representative commodities -- and also what period of time ir under consideration.

Most of these refinements can be set aside, however, in analyzing recent experience and the current situation. The dominant fact of recent experience has been the more or less steady appreciation of the dollar against major foreign currencies (and gold) since late 1980. While there have been temporary interruptions, the dollar has basically been moving in one direction. At each step along the way, there has been no shortage of "expert" opinion that the dollar was clearly overvalued and would soon reverse its course. This suggests that the entire process since 1980 has been driven by a different set of forces than many economists and financial commentators were taking into account.

It is clear, in retrospect, that too much attention has been paid to crude purchasing power parity calculations, comparing the cost of a basket of goods in various countries relative to some base period as a guide to the correct exchange rate. While perhaps not totally devoid of merit, such calculations ignore the fact of closely interrelated international money and capital markets within which the daily volume of transactions dwarfs in magnitude the accompanying trade transactions. Some of this is simply financial churning but in today's world much of it reflects individual and corporate decisions to alter the composition of investment portfolios. The result can be -- and has been -- massive and continuing flows of capital from the rest of the world to this country. This is quite a different process from the older textbook descriptions in which merchandise trade flows take the lead and the financing transactions follow passively in their wake. Capital flows have dominated the picture since 1980. Unless that fact is clearly understood, erroneous conclusions are very likely to be drawn.

Explanation of the Dollar's Rise in Value Since 1980

The changing position of the capital account of the U.S. balance of payments is shown in Table 1 attached to this statement. The U.S. capital account has moved from a relatively small net outflow in 1980 to a net inflow including the statistical discrepancy of more than $100 billion in 1984. As a matter of statistical necessity, the U.S. current account balance has moved into deficit position, equal in amount and opposite in sign. Why should primary attention be directed to the capital transactions in analyzing the process that has been underway since 1980? Simply because, as shown in Chart 1, the dollar exchange rate has appreciated steadily during the same period. This means that there has been chronic excess demand for dollars in the foreign exchange markets, generated by the strong desire to invest in the U.S. economy. If the deteriorating current account balance had been the driving force with imports rising more rapidly than exports, there would have been a chronic excess supply of dollars and a steadily depreciating dollar.

While there probably would be general agreement with this aspect of recent experience, there is considerable disagreement as to the underlying factors that induced the capital inflows in the first place. One popular line of explanation -- sometimes in danger of achieving the status of conventional wisdom -- has been that large U.S. budget deficits have caused high interest rates which have pulled in foreign capital. While this may seem superficially plausible, it is important to recall that since 1980 the dollar has strengthened when the U.S. economy was expanding and when it was contracting, when budget deficits were small and when they were large, when interest rates were high and when they were low.

The budget deficit explanation of the capital inflows and the trade deficit cannot survive even the most elementary empirical testing. There are two crucial linkages: between budget deficits and interest rates and between interest rates and international capital flows. Each of these key linkages is weak to nonexistent on the basis of recent U.S. experience.

It is taken as axiomatic by some that interest rates will be higher with a large budget deficit than a small one. This is at variance with recent U.S. experience in which U.S. interest rates have come down significantly since mid 1982, and even more sizably since 1980, at the very time when U.S. budget deficits and projections of future deficits on a current services basis were widening rapidly. The U.S. Treasury examined the full range of the academic literature and conducted its own empirical investigations before concluding in 1984 that "it is not possible to establish statistically a systematic relationship between Federal budget deficits and interest rates." There are too many good reasons why the U.S. budget deficit should be reduced to rely on a nonexistent statistical connection with interest rates.

The additional linkage between U.S. interest rates and capital inflows from abroad is sometimes also taken to be self-evident although the actual situation is complex and does not support the idea of a close connection. Interest differentials in favor of the dollar were actually wider in 1980 when the inflow of funds and the appreciation of the dollar began than they have been recently. Therefore, it is not possible to invoke high U.S. interest rates and an interest differential in favor of the dollar as the sole or even predominant reason for the dollar's strength. Undoubtedly, interest rate differentials can temporarily play an important role in exchange rate movements, and they are always one element in the picture, but they cannot explain the continuing net capital inflows to the U.S. or the lasting strength of the dollar.

The U.S. situation since 1980 has featured a massive net capital inflow without parallel in the postwar period. This has been the driving force in exchange markets. The reasons include low U.S. inflation, generally good to excellent U.S. economic performance, and the traditional role of the U.S. money and capital markets as a safe haven for foreign funds when there are economic difficulties abroad. Above all, the free-market orientation of the Reagan Administration and the higher prospective rate of return here on productive investment has acted as a powerful magnet attracting foreign capital. Flows of the type, magnitude and duration we have experienced are not induced by fleeting interest rate differentials as if foreigners were shopping for a better money market fund. These massive flows have been induced by a generalized perception that the U.S. economy has found a new direction and offers significantly higher after-tax rates of return on productive investment.

Capital inflows and the appreciating dollar are not the only influence on the U.S. balance of payments by any means. Differential rates of growth here and abroad, trade barriers, changing patterns of competitive ability, and U.S. export losses associated with the LDC debt situation have all exerted an important influence from time to time. The list could be lengthened. It is also important to recognize that there has been a changing pattern within the capital accounts in the last 18 months or so. As shown in Table 1, the more recent pattern has been a continuing net capital inflow to this country because of reduced U.S. outflows, partly because of reduced bank lending to Latin America. The changing composition may imply some future tapering off of the net inflow but it is too soon to be sure.

The strength of the U.S. dollar is a testimonial to the essential correctness of the policies that the Reagan Administration has introduced. Greater emphasis on incentives to work, save and invest -- the supply side of the economy -- has been coupled with effective control of inflation -- to which the strong dollar has itself made its own important contribution. As a result, the U.S. economy has been strong, capital has flowed to this country and the dollar has been bid up in price. It is understandable that we do not want to see those successful policies reversed in an effort to bring the dollar down. This would be very unwise in our opinion. But we are not oblivious to the fact that the strong dollar has created problems. I will discuss two of the more frequently heard objections to the current policy posture. First, that the U.S. budget deficit is draining funds from abroad, and second, that a strong dollar is doing serious damage to U.S. industry and agriculture.

The U.S. Budget Deficit and Inflows of Foreign Capital

The U.S. budget deficit results from an excessive rate of Federal spending while tax receipts remain in a normal range. This can be seen clearly in Chart 2 attached to my prepared statement. Outlays have been running in the 24 to 25 percent range as a percent of GNP, well above the historical average. Receipts, on the other hand, are in a normal range, running close to 19 percent of GNP despite the Reagan tax cuts. The Federal budget deficit results from overspending, not because the American people are undertaxed.

The budget reduction efforts now under Congressional consideration recognize that reality by concentrating on outlays. The effort to reduce the budget deficit is extremely important to our future economic well being and deserves full bipartisan support. It is true that the immediate effect on the value of the dollar of cutting the growth of Federal outlays and narrowing the deficit is open to question. Such action might well strengthen the dollar in the very short run since the improved outlook for fiscal responsibility might encourage even larger capital inflows to this country. Such temporary strengthening might, however, be more than offset if the Fed were to move to higher rates of monetary growth in the wake of successful budget cutting efforts. Opinions will probably differ on the likelihood and effectiveness of such a change in policy mix, but the net short-run effect might well be an easing of interest rates and some decline in the value of the dollar.

A much stronger case can be made that action in reducing the budget deficit would result in reduced dependence on foreign capital over the longer run. The U.S. savings pool is depleted dollar-for-dollar by government deficits which are an act of dissaving. A move away from large budget deficits over time would be desirable in its own right and could possibly lead to slightly greater reliance on domestic savings and somewhat less on foreign. Up to this point, the inflow of foreign savings has been clearly beneficial. It has kept U.S. interest rates lower than they might otherwise have been and permitted a larger volume of productive capital formation in this country. However, there is no overriding reason to risk a potential future financing problem. Instead, we must reduce Federal spending growth now to place our fiscal house in order.

Despite the importance of the budget cutting effort, it should be stressed that dependence on foreign savings at the present time is typically exaggerated. For example, the proportion of U.S. government securities going to foreigners has been declining. Taking the period since 1970 as a whole, borrowing from foreigners has averaged 16 percent of total borrowing from the public. Since 1980 the proportion has fallen to only 8 percent. About four-fifths of the foreign-held debt is in the hands of foreign central banks or other official institutions and all of it is denominated in dollars.

In a broader tableau of total U.S. savings and investment, foreign inflows have been making an important contribution in recent years. Foreign saving was about 2-1/2 percent of GNP last year and appears as negative net foreign investment in Table 1 attached to this statement. It is important to note that these foreign inflows are entirely voluntary and are responding to free market forces. It is wrong, therefore, to imply as some commentators have that the U.S. is deliberately vacuuming up the world's savings to finance its budget deficit. The plain fact of the matter is that foreigners place their money here despite our budget deficits not because of them. The crucial question is whether or not they would continue to do so indefinitely in the absence of action on our part to reduce the deficit through spending restraint. It seems unlikely that they would.

Effects of a Strong Dollar on the U.S. Domestic Economy

A more difficult question is the net effect of the appreciation of the dollar on the U.S. domestic economy. At one level, the answer is simple. The dollar has strengthened in response to free market forces. Exchange markets are efficient and reflecting the best information available to market participants on economic prospects here and abroad. There is a strong presumption that the movement of the dollar has been beneficial. There are negative effects upon particular sectors of the U.S. economy but these are usually outweighed by the benefits overall, so long as the strong dollar is reflecting fundamental factors of supply and demand here and abroad.

It is also necessary to recognize that there is a connection between monetary policy and the U.S. exchange rate. Confidence in the purchasing power of the dollar has been restored and people worldwide want to rebuild their dollar holdings. Along with attractive investment opportunities in this country, this may have led to a significant upward shift in the demand for dollars. To the extent that monetary policy does not fully accommodate the international demand for dollars, the dollar appreciates more than it should ideally. In such a case the overvaluation of the currency would be a function of excessively tight monetary policy. A good example of this type of problem was the sharp rise in the dollar exchange rate and the decline in commodity prices during the second half of 1984 when money supply growth was held close to a zero rate.

It is easy to cite favorable aspects of the appreciation of the dollar.

- Appreciation of the dollar has helped to control inflation. Estimates of the quantitative impact vary. It is common to suggest that 20% or so of the observed improvement in inflation may be due to the dollar. Some would place the estimate even higher.

- Appreciation of the dollar has enlarged consumer real income. In technical terminology, the U.S. terms of trade have been improved and we obtain a larger volume of imports per unit of our exports.

- Appreciation of the dollar has been associated with a larger inflow of foreign saving and a higher rate of U.S. capital formation than might otherwise have occurred.

- Higher U.S. real income and imports have provided a badly needed stimulus to the international economy at a time when growth outside of the U.S. has been sluggish and the LDC debt problem has provided additional complications.

It is only fair to concede that a stronger dollar has had negative effects at least from the standpoint of large sectors of the economy. Export industries and industries facing foreign competition have faced increasing difficulties. Some even argue that the U.S. economic structure is experiencing damaging effects of a lasting nature. This frequently is phrased in terms of a too rapid acceleration of the shift to a service economy. Such a trend is of long standing, of course, not only in the U.S. but in other high income countries. For example, the proportion of U.S. employment in service-producing activities has risen as follows: 1954, 59.7%; 1964, 64.0%, 1974, 68.3%, and 1984, 73.6%. Such shifts, along with a declining proportion of the work force in agriculture, appear to be an inevitable consequence of economic progress and rising standards of living. As such, they are hardly to be decried or resisted.

Much of this shift reflected the faster productivity growth in the manufacturing sector of the economy than in service producing industries. Value added in manufacturing as a share of total real GNP has remained fairly steady at about 24 to 25 percent throughout the postwar period. The share has deteriorated slightly in the past few years.

Some recent statistics are, however, at least superficially disturbing.

- During the period 1979-1984 (chosen to minimize purely cyclical effects) total U.S. employment grew by 4.3 million.

- Job gains in services (3.6 million) and retail trade (1.3 million) more than accounted for the rise.
- Employment in manufacturing actually declined. Job increases in manufacturing occurred mainly in
  - office equipment (largely computers)
  - communications equipment, electronics components and instruments
  - gains in these high-tech pursuits accounted for only 9 percent of the 4.3 million increase in total employment.
  - Over this span, real output in manufacturing has increased 6.6 percent, and the manufacturing share of real GNP has dropped only about one percentage point.

More recently as the trade deficit has moved beyond the $100 billion mark there has been a virtual stallout in the U.S. manufacturing sector. Industrial production has been virtually flat for the better part of the last year. Manufacturing employment is down over 130,000 since January and is now below levels reached last July and August.

Agricultural exports dropped nearly 13 percent between 1981 and 1984, due in large measure to reduced price competitiveness. Other factors -- LDC debt problems, rigid U.S. price supports, increased self-sufficiency in importing countries -- also contributed, but the strong dollar has pushed prices of our agricultural exports (in local currencies) to near-record levels while U.S. prices are down sharply from 1981. The weakened foreign demand has contributed to a lower U.S. price which in turn has been translated into a farm cost-price squeeze and declining farmland prices.

The rise in the dollar may be hastening resource shifts in the economy which would have taken place in any event although perhaps more slowly. The case for interference with free market processes is never strong and certainly does not appear to be in this case. Despite the attention given to financial aspects of the rise in the value of the dollar the more important and poorly understood effects are those taking place in real activity. Heavy burdens are falling on some sectors and groups. This is inevitable in the face of such a large change in the exchange rate and probably beneficial in the long run for the U.S. economy, but the issues are not simple or the answers always straightforward. In particular, the Federal Reserve needs to be sure that the dollar is not being kept artifically scarce with consequent adverse effects on the U.S. economy.

Possible Policy Responses

The only immediate policy actions which make a great deal of sense are efforts to slow the rate of growth in Federal outlays and reduce the Federal budget deficit and pursuit of a monetary policy that avoids excessive tightness. Opinions will differ on how predictable the effects on the value of the dollar might be, but there can be little doubt that the ultimate impacts on the U.S. economy would be enormously beneficial.

In addition to this fundamental action to improve U.S. economic performance, the recent Bonn Summit Conference agreed upon the need to remove structural rigidities in the European economies. As Europe begins to solve its structural problems and creates an environment more hospitable to investment, then capital will be more inclined to stay in Europe and not seek alternative investments in the United States. When Europe strengthens, their currencies will strengthen too. Much the same line of argument is applicable to the LDC situation as well.

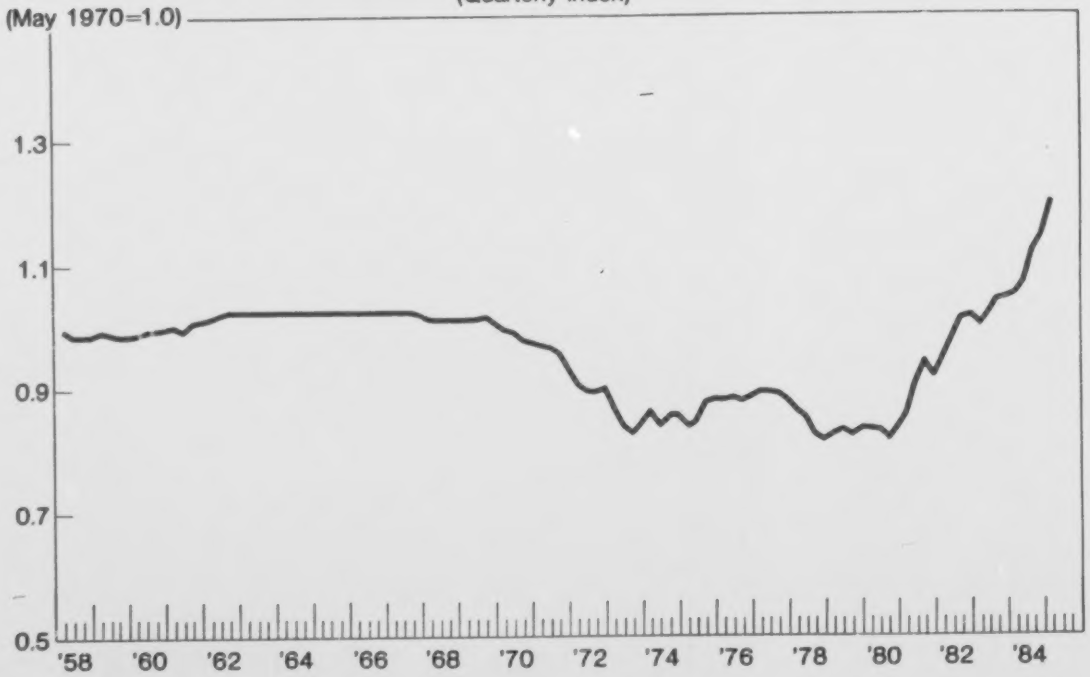
Other proposals are much less positive in nature. They range from import surcharges, and investment restraints to exchange market intervention. None of them would make a useful contribution. All of them run directly counter to the basic principles of this Administration and have been rejected on numerous previous occasions.

In our opinion, the best course of action at the present time is to press ahead with the vital task of reducing the Federal budget deficit. That action along with stronger economic performance abroad should gradually reduce the strains associated with the appreciation of the dollar in recent years.

Chart 1

TRADE-WEIGHTED VALUE OF THE U.S. DOLLAR

(Quarterly Index)

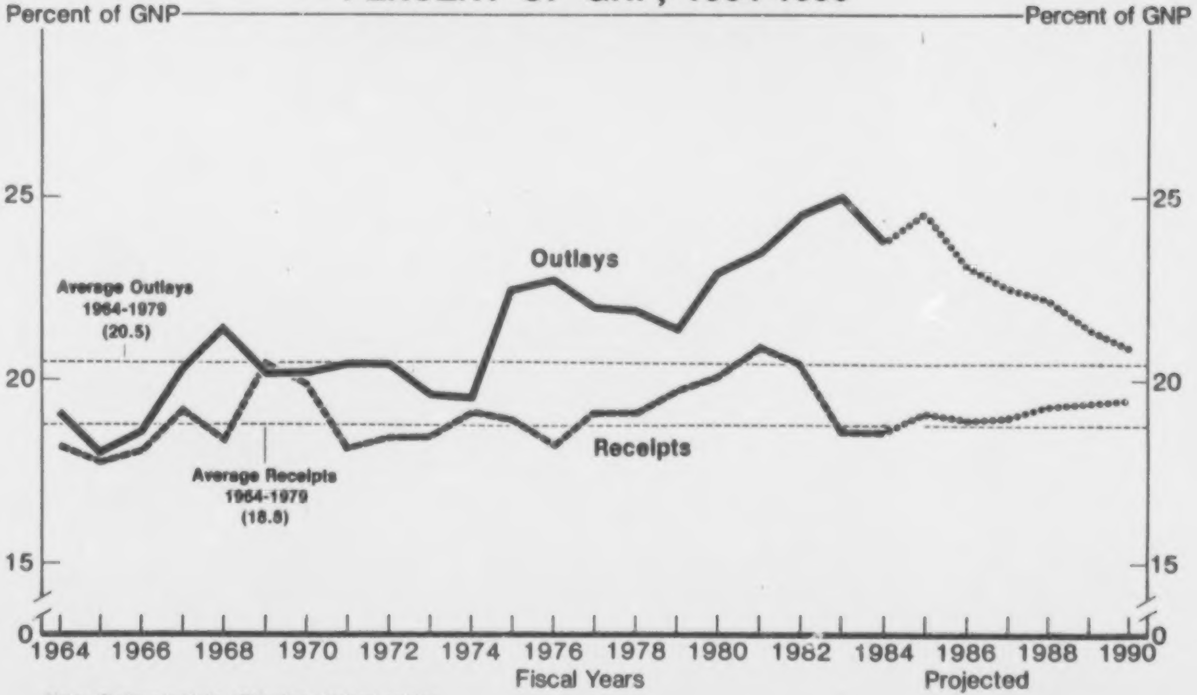


Source: Morgan Guaranty

May 13, 1985-A419

Chart 2

OUTLAYS AND RECEIPTS AS PERCENT OF GNP, 1964-1990



Note: Outlays include off-budget federal entities.

April 19, [illegible]

Table 1

U.S. Capital Account, 1980 to 1984
($, billions)

	1980	1981	1982	1983	1984*
1. Capital inflow to U.S.	58	81	95	82	93
less					
2. Capital outflow from U.S.	86	111	119	50	21
equals					
3. Net identified capital inflow	-28	-30	-24	32	72
plus					
4. Statistical discrepancy and other (inflows)	26	24	33	9	30
equals					
5. Net capital inflow to U.S.	-2	-6	9	42	102
…………………………………………					
6. Current account balance	2	6	-9	-42	-102

---

* preliminary.
+ implies inflow, - an outflow.

Table 2

Gross Saving and Investment as Shares of GNP

	Decade Averages			Annually				
	1950s	1960s	1970s	1980	1981	1982	1983	1984
	Percent of GNP							
Total gross saving*	15.9	16.0	16.0	15.4	16.4	13.3	13.2	15.1
Private	16.0	16.3	16.8	16.5	17.2	17.1	17.3	18.5
Personal	4.8	4.5	5.0	4.2	4.6	4.4	3.6	4.3
Corporate undist. profits	2.4	3.3	2.2	1.2	1.4	1.0	2.3	3.2
Capital consumption allow.	8.8	8.6	9.6	11.1	11.2	11.7	11.4	11.0
Government	-0.1	-0.3	-1.0	-1.2	-0.9	-3.8	-4.1	-3.3
Federal	0.1	-0.3	-1.8	-2.3	-2.2	-4.8	-5.4	-4.8
State & local	-0.2	0.0	0.8	1.2	1.3	1.1	1.3	1.4
Total gross investment*	16.2	15.9	16.0	15.5	16.6	13.3	13.3	14.9
Gross private domestic inv.	16.0	15.4	16.0	15.3	16.4	13.5	14.3	17.4
Business fixed investment	9.6	10.0	10.7	11.7	12.0	11.4	10.7	11.6
Residential construction	5.4	4.4	4.6	3.9	3.5	3.0	4.0	4.2
Inventory investment	1.0	1.1	0.8	-0.4	0.9	-0.9	-0.4	1.6
Net foreign investment	0.2	0.5	0.0	0.2	0.2	-0.2	-1.0	-2.5

*Total saving and total investment may differ by a "statistical discrepancy" in the measurement of investment and saving flows and for some periods by capital grants not shown above.

Chairman LaFalce. Thank you very much, Mr. Johnson. It really was excellent testimony, and I tried to liven it up with questions along the way.

I defer my questioning to Mr. Shumway after those intrusions though.

Now let's hear from a constituent, at least a corporate constituent, and I am not sure where he lives. We are very pleased to have the senior vice president and director of finance and administration for the Eastman Kodak Co., Mr. Paul L. Smith.

Mr. Smith.

STATEMENT OF PAUL L. SMITH, SENIOR VICE PRESIDENT AND DIRECTOR OF FINANCE AND ADMINISTRATION, EASTMAN KODAK CO., ROCHESTER, NY

Mr. Smith. Thank you, Mr. Chairman, Mr. Shumway, and panel colleagues.

As introduced, I am Paul L. Smith, senior vice president and director of finance and administration of the Eastman Kodak Co., a 105-year-old manufacturer of consumer and professional photographic products, information management products and systems, health science products, chemicals, fibers, and plastics.

The effect of the strong dollar on U.S. industrial competitiveness in the world marketplace is one of the most important issues facing American business and I believe the Nation.

I commend this subcommittee for calling this hearing to focus on the issue, and I also appreciate the opportunity you have given to me to appear before you this morning.

Kodak has from its beginning been selling products throughout the world. We have regularly ranked among the top U.S. companies in export sales. In 1981 we contributed a positive $1.6 billion to the U.S. balance of payments. Since 1981 our trade balance contribution has slipped, declining to $1.4 billion last year.

About 35 to 40 percent of our revenues come from overseas, and about half of that comes from products produced in the United States where about 20,000 of our employees are in export related jobs. Their jobs and many more around the world depend on Kodak products being purchased in free and open competition.

However, today the strong dollar gives an unearned advantage to manufacturers abroad. For example, importers can sell at lower prices because such goods have been made at a cost dominated in cheaper local currencies, thus allowing those competitors to gain a market share without sacrificing any profits, or importers can increase profits by holding prices level and then converting dollars from U.S. sales to local currencies at advantageous rates of exchange.

In either case, our products become more expensive when compared to similar ones made at nondollar base costs. Consequently we lose both sales and earnings.

Similarly, in Europe for each of the last 4 years the exchange effect has been the same as handing our competitors a 15-percent price increase or forcing us to make a 15-percent price decrease.

Chairman LaFalce. That is per year?

Mr. SMITH. That is per year. Few companies anywhere could survive a 4-year compounded negative effect of that magnitude and some haven't.

Let's look for a moment at the last 4 years. We can calculate part of the exchange rate's annual effect on earnings by translating our sales revenues abroad to dollars at the current and prior year exchange rates. The upward surge of the dollar from just 1983 to 1984 reduced our earnings in the latter year by about 40 cents a share.

The cumulative effect of the strong dollar over the past 4 years reduced Kodak's 1984 annual earnings by about $2.20 a share, or more than $500 million. That actually understates the situation. It fails to account for earnings foregone due to lost sales or lost margins.

Our estimate is that this calculation is indicative of only one-half to one-third of the currency movement's real effect. Using what we consider a conservative approach and counting the calculated value as only half of the actual impact, we estimate our lost earnings per share were actually $4.20 or about $1 billion.

That is the cumulative effect of 4 years of such currency changes on 1984 annual earnings only. The impact has continued during our first fiscal quarter which ended March 24, 1985. Relative to the first quarter of 1984 our loss net earnings were roughly 15 cents a share or $35 million. Relative to 1980, our first quarter 1985 earnings alone were reduced by about $150 million.

As I have already said, however, the real impact is at least twice this or about $300 million equivalent to $1.30 a share.

Now if we total our earnings over the past 4 years, 1981, 1982, 1983, and 1984, and compare them with what they might have been had the dollar stayed at its 1980 level, the loss in retained earnings would come to an estimated $3 billion. Those dollars were not available for us for investment in jobs, in research or in expansion or for payment of taxes to Federal, State, and local governments on an increased earnings level.

Clearly American multinational corporations have been dealt a serious blow by the strong dollar. We will do all within our power to cope, but there are limitations. For Kodak suddenly moving manufacturing to other countries is not practical because of the long lead time and the magnitude of investment required to construct a complex manufacturing facility. But we have not been sitting idly by waiting for the dollar to come down.

Kodak manufacturing commitments in the United States are substantial. To ensure our technological lead, we invested more than $800 million in research and development last year, and we have budgeted over $1.2 billion for capital improvements in the United States in 1985.

In spite of that commitment, we have had to modify our approach in order to minimize the effects of the strong dollar. We improved our productivity 13 percent last year. We consolidated manufacturing facilities. We purchased more foreign made parts and located some assembly and subassembly work at nondomestic locations.

But perhaps the most dramatic change we have made has been the purchase of whole new lines of finished products manufactured abroad and supplied to us by other companies. Foreign purchases of parts and products by us during 1984 were up more than 100 percent from the previous year.

My point is this. Continuing inequity in currency values will force American companies, Kodak included, to the trend of more and more offshore manufacturing. This raises two basic points.

First, America's manufacturing infrastructure base is vital. One recent survey in New York State shows that every manufacturing job generates three service sector jobs.

The second point was well stated by a leading retailer in my home city of Rochester who asked "What good will it do to have lower priced merchandise if I have no consumers with jobs and dollars to spend?" He was perceptive in seeing the long-term problem.

We are not asking for special treatment and we do not advocate various protectionist measures. We continue to support free trade even though we are well aware that the abnormally strong dollar gives offshore manufacturers an opportunity which they have not really earned. But I also recognize that the issue of the dollar's strength does not yield to simple solutions.

As we discuss more fully in our submitted white paper on the strong dollar, its causes are numerous, complex and interwoven. While low inflation and a strong U.S. economy have contributed to the dollar's strength, high real interest rates and the huge Federal deficit have worked to compound the problem.

The deficit with its consequences for the dollar must be dealt with promptly. It threatens the future of the American industry infrastructure. We simply cannot give away our competitive advantages, particularly in the manufacturing sector by letting the dollar continue to rise relentlessly.

Thank you.

[The prepared statement, with attachments, of Paul L. Smith, entitled "The Effects of a Strong Dollar," follows:]

THE EFFECTS OF A STRONG DOLLAR

Testimony of

Paul L. Smith

Senior Vice-President

and

Director

Finance and Administration

Eastman Kodak Company

before the

House Subcommittee

on Economic Stabilization

May 14, 1985

Mr. Chairman, Members of the Committee, I am Paul L. Smith, Senior Vice-President and Director, Finance and Administration of Eastman Kodak Company -- a 105-year-old manufacturer of consumer and professional photographic goods, information management products and systems, health science products, chemicals, fibers and plastics.

The effect of the strong dollar on U.S. industrial competitiveness in the world marketplace is one of the most important issues facing American business. I commend the Committee for calling this hearing to focus on this issue ... and I also appreciate the opportunity you have given me to appear before you this morning.

I want to share with you some quantitative information regarding the effect of a strong dollar on a major, U.S.-based multinational manufacturing concern.

Kodak has, from its very beginning, been selling products throughout the world. In 1983, we were the 10th largest exporting company in America, and last year our exports helped us achieve a positive contribution of 1.4 billion dollars to the U.S. balance of payments. (See Attachment A)

In fact, we have regularly ranked in the top group of U.S. companies in export sales.

About 35 to 40 percent of our revenues come from overseas ... and about half of that comes from products produced in the United States, where about 20,000 of our employees are in export-related jobs.

Their jobs and many more around the world depend on Kodak products being purchased in free and open competition. However, today that competition is distorted.

A strong dollar gives an unearned advantage to manufacturers abroad who compete with U.S. manufacturers -- in either our domestic or export markets. This means, for example, that in domestic markets:

- importers can lower prices of goods they sell here because such goods have been made at a cost denominated in cheaper, local currencies -- thus allowing those competitors to gain market share without sacrificing profits; or,

- if they choose, importers can increase profits by holding prices level, then converting dollars from U.S. sales to local currencies at advantageous rates of exchange.

In supplying international markets, Kodak's approach has been one of manufacturing balance. About half of the products we sell abroad are manufactured here. The other half represents products manufactured in facilities outside the U.S., often with materials supplied from our U.S. resources.

In either case, our products become more expensive when compared to similar ones made at non-dollar related costs. Consequently, we lose earnings because of decreased margins, lower volumes, or both.

For example -- in Europe -- in each of these last four years, the exchange effect has been virtually the same as handing our competitors a 15 percent price increase or forcing us to make a 15 percent decrease. Few companies have total margins as high as 15 percent. So a one-year negative effect, to say nothing of a four-year compounded negative effect of that magnitude, is something most companies anywhere could not survive.

I am mindful of the record-high levels the dollar has reached this year and also of its moderation during the last few weeks, but look for a moment at the previous four years. (See Attachment B)

We can calculate part of the exchange rate's annual effect on earnings. This can be done by simply translating our sales revenues abroad back to dollars, then comparing that with the value that would have resulted had the dollar stayed at its value for the prior year.

The upward surge of the dollar from 1983 to 1984 reduced our earnings in the latter year by about 40 cents a share. The cumulative effect of the strong dollar over the past four years reduced Kodak's 1984 earnings by about $2.20 a share or more than 500 million dollars. (See Attachment C)

That actually understates the situation. It fails to account for earnings foregone due to lost sales or lost margins. Our estimate is that this calculation is indicative of only one half to one third of the currency effect.

Using a conservative approach -- counting the calculated value as only half of the actual impact -- we estimate our lost earnings per share were actually $4.20 or about one billion dollars. That is the cumulative effect of four years of such changes on 1984 earnings. If we had not incurred those currency losses, our earnings would show a four-year 15 percent compounded increase from 1980. Instead, our results were 20 percent below those of 1980. (See Attachment D)

The impact has continued during our first fiscal quarter which ended March 24, 1985. Relative to the first quarter of 1984, our lost net earnings were 15 cents a share or roughly $35 million. Relative to 1980, our first quarter 1985 earnings alone were reduced by about $150 million. As we have already said, however, the real impact is at least twice this, or about $300 million, equivalent to $1.30 a share.

If we total our earnings over the past four years and compare them with what they might have been had the dollar stayed at its 1980 level, the loss in retained earnings would come to an estimated three billion dollars. Those dollars were not available for investment in jobs, in research, or in expansion ... or for payment of taxes to federal, state and local governments.

Clearly, American multinational corporations have been dealt a serious blow by the strong dollar. They will do all within their power to cope, but there are limitations.

For Kodak, suddenly moving manufacturing to other countries is not very practical because of the lead time and the magnitude of investment required to construct a complex manufacturing plant.

But we have not been sitting idly by waiting for the dollar to come down. In a growing worldwide photographic market, we are continuing to work hard to maintain our positions.

To ensure our technological lead, we invested more than 800 million dollars in research and development last year. We have had an intensive effort underway for several years to improve productivity, and half of our 1985 capital budget will be directed toward productivity and quality improvements.

Our efforts have been successful in that our 1984 productivity was up 13 percent, or nearly four times the national average (which is at its highest in thirteen years). Productivity efforts have included not only process and equipment modification ... but also reductions in worldwide employment which, at the start of this year, was down nearly 2 percent from 1980.

Kodak manufacturing commitments in the U.S. are substantial. To grow our existing base, we have budgeted more than 1.25 billion dollars for capital improvements in the U.S. during 1985. In spite of that commitment, we have had to modify our traditional mode of doing business in order to minimize the effects of the increase in value of the dollar.

We have consolidated the manufacture of many products. We have located a modest amount of assembly and sub-assembly work at our locations outside the United States. We have bought more foreign-made parts from other manufacturers.

These efforts are all new to us, but perhaps the most dramatic change has been the purchase of whole new lines of finished products manufactured abroad and supplied to us by other companies. Foreign purchases of parts and products during 1984 were up more than 100 percent from the previous year.

My point is this: continuing inequity in currency values will force American companies, Kodak included, to trend more and more to off-shore manufacturing.

Being competitive in manufacturing cost is always our objective, but even the cost advantages of a 13 percent productivity increase are not sufficient to offset the dramatic appreciation of the dollar.

Despite our use of a sophisticated currency trading operation, our exposure to currency fluctuations remains severe. And, here again, what is possible is very small in comparison to what is needed.

It seems to me that the U.S. is in a serious situation with the very survival of its manufacturing base at stake. At the very least, there has already been a setback that will prevent many companies, in the foreseeable future, from returning to former performance levels. Some industries may already be at the point where projected return on investment cannot justify construction of new plants, or even modernization of existing facilities.

We are not asking for special treatment, and we do not advocate import surcharges, quotas or other protectionist measures. We continue to support free trade even though we are well aware that the abnormally strong dollar gives offshore manufacturers an opportunity which they have not earned and which U.S. companies have not fumbled away.

But I also recognize that the issue of the dollar's strength does not yield to simple solutions. As we discuss more fully in the attached White Paper on the Strong Dollar, its causes are numerous, complex and interwoven. (See Attachment E)

While low inflation and a strong U.S. economy have contributed to the dollar's strength, high interest rates and the huge federal deficit have worked to compound the problem.

Over the past 10 years, the deficit has increased from less than one percent of the U.S. Gross National Product to nearly five percent. Financing this deficit fuels real interest rates, which are already high by historical standards and generally higher than rates of return available elsewhere.

Borrowing made necessary by the public debt contributes to high interest rates, which, in turn, contribute to the continued strengthening of the dollar -- beyond what economic realities would suggest.

The deficit -- with its consequences for the dollar -- must be dealt with promptly. It threatens the future of American industry. We simply cannot give away our competitive advantages by letting the dollar continue to rise relentlessly.

# # #

I would like to conclude by making just three brief points:

- First, we view America's manufacturing base as vital. It is the wellspring of our economy. One recent survey in New York State shows that for every job created by manufacturing industry, another three jobs are generated in the service sector.

- Second, we need to question the ultimate worth of relying on grand-scale importing of goods made cheaper by virtue of the strong dollar. A leading retailer in my home city of Rochester has asked this question: "What good will it do to have lower price merchandise ... if I have no consumers with jobs and dollars to spend?"

- And, last, let me emphasize that your work and leadership in seeking fair, direct solutions is worth the strongest investment of time and talent. We hope to help you make Americans more aware of the problems we face and the solutions we seek. In fact, recently we sent a special letter to Kodak shareowners discussing the points we have raised here. (See Attachment F) In their behalf, we again commend your initiative in examining this issue.

Thank you.

ATTACHMENTS:

A. Kodak Balance of Payments

B. Relative Dollar Value

C. Earnings Loss Per Share

D. Net Earnings

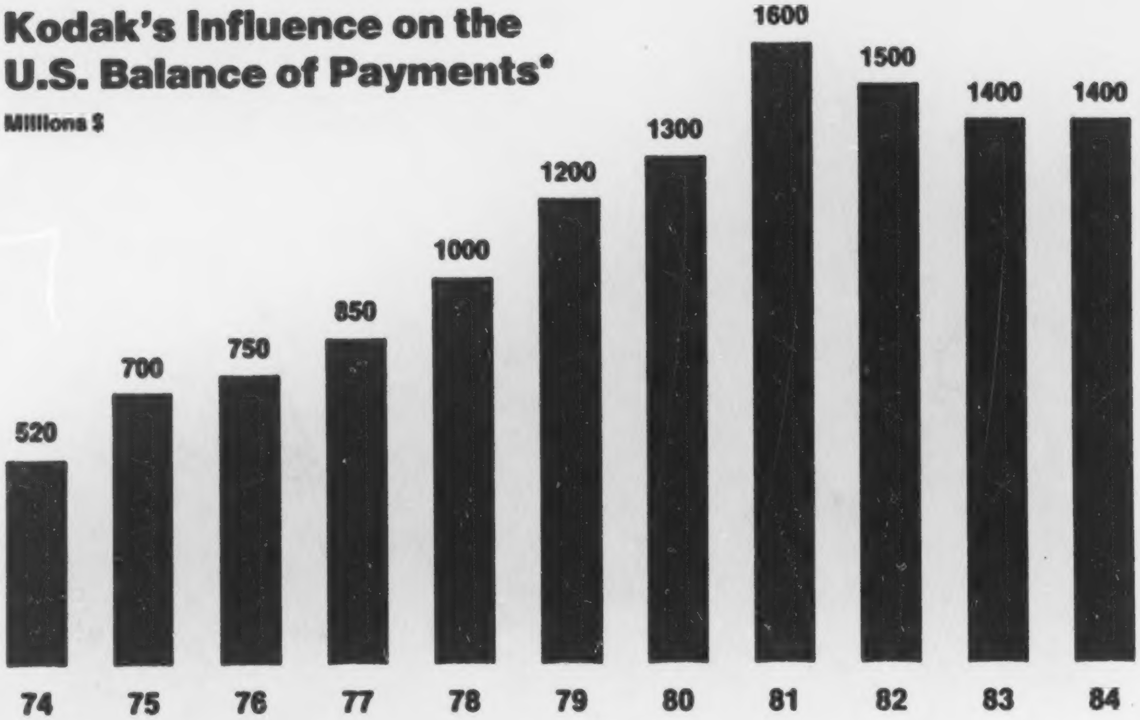
E. White Paper on the Strong Dollar

F. Shareowner Letter

ATTACHMENT A

Kodak's Influence on the U.S. Balance of Payments*

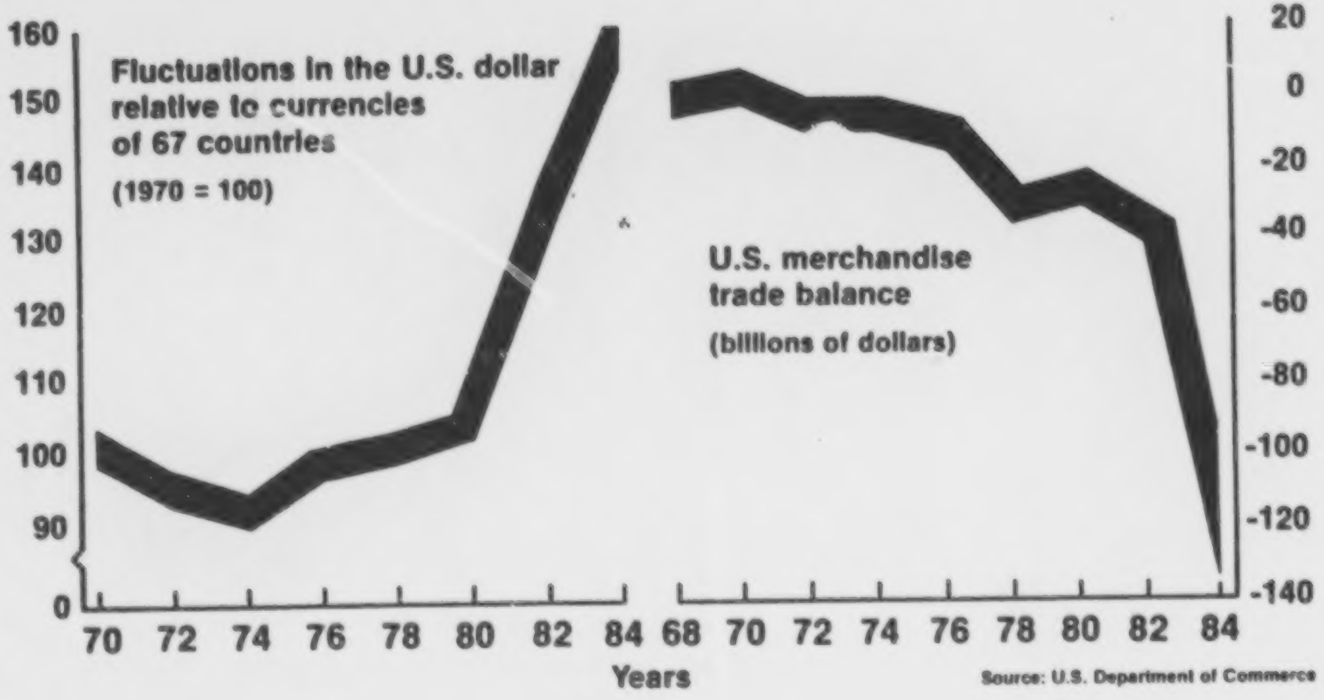
Millions $



* The excess of exports, dividends, royalties, and other income from abroad over imports, new dollar investments outside the United States, and dividends to shareowners in other countries.

ATTACHMENT B

U.S. Exchange Rate and Trade Deficit



Source: U.S. Department of Commerce

ATTACHMENT C

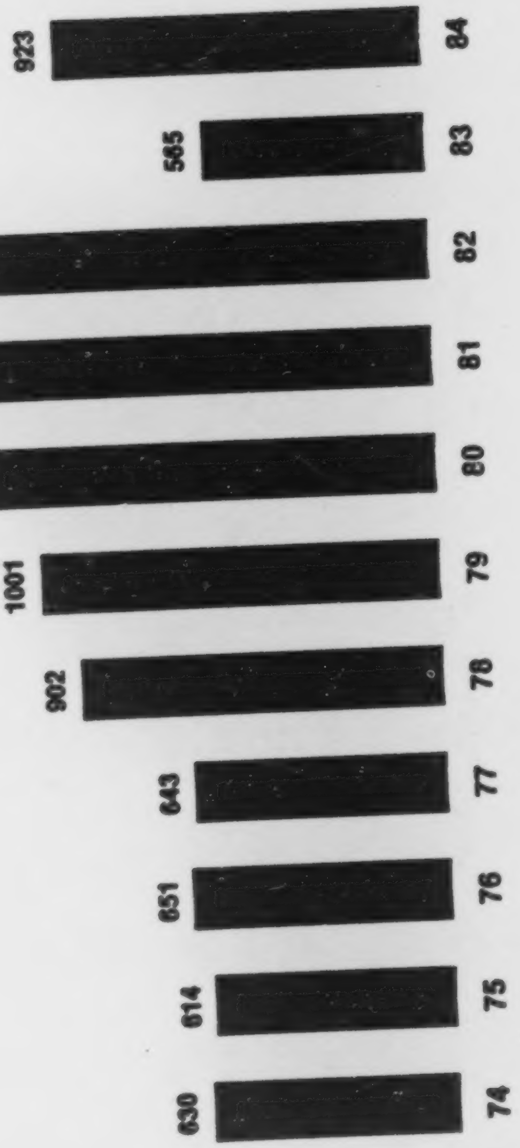
Eastman Kodak Company — Effect of Dollar (Year to Year)

	Earnings Lost ($ million)	Lost Earnings/Share ($/share)
1981	164	.67
1982	164	.67
1983	107	.46
1984	100	.40
TOTAL	$535	$2.20

ATTACHMENT D

Kodak Net Earnings

Millions $



ATTACHMENT E

White Paper on the Strong Dollar

WHITE PAPER ON THE STRONG DOLLAR

CONTRIBUTING FACTORS

The factors contributing to the strong dollar are numerous, complex and intertwined. An historical event which helped set the stage for today's strong dollar (as well as the weak dollar of the late 1970's) occurred in 1971 when the last links between the dollar and gold were severed. After that date, currency values were allowed to float and many factors started to influence currency values. The following widely recognized factors are presently supporting the strength of the dollar:

1. Safe Haven. The United States is currently considered to be a safe haven for investment because of our large and growing economy, our political stability and our recognized position as a world leader.

2. U.S. Economic Recovery. Since the last recession, the U.S. economy has recovered sooner and at a faster rate than the other economies of the world. The resultant expectation of greater growth in the U.S. attracts foreign interests.

3. Capital Inflow. During the last few years there has been a large net capital inflow into the U.S. which has added to the strength of the dollar. This is a relative phenomenon in that most data indicate that the absolute capital inflow into the United States has not risen significantly; however, the capital outflow from the U.S. has dropped considerably as domestic banks have cut back on their loans to developing countries.

4. High Real Interest Rates. Although recently U.S. interest rates have come down several points, our rates still remain high when compared with interest rates of other countries in a context of expected low U.S. inflation and continued economic growth.

WHAT MIGHT BE DONE ABOUT THESE FACTORS?

The U.S. could intervene in the currency markets to drive down the value of the dollar. But there is reasonable agreement that such an effort would have only limited effect on a day-to-day basis and would not give rise to stability in the currency markets.

Often with international issues, a certain amount of "jawboning" can be effective. For example, the Administration might make statements that the dollar should be lower and our policy will be to move it down in an orderly manner. However, financial markets are typically fragile and such statements may result in panic. Martha Seger, Federal Reserve Board governor, has warned that "should market participants perceive, rightly or wrongly, any shift in policy or economic circumstances that would make the growing proportion of dollar assets in portfolios less attractive, the dollar would drop precipitously, with potentially disruptive effects on financial markets." Such a sharp drop in the dollar's value would give the U.S. economy an inflationary shock.

Another approach would be to study and perhaps modify the floating exchange rate system in cooperation with other major countries. Although such an effort might take a considerable amount of time before various countries would even gather to talk, and an even longer period before agreement on any solution, nevertheless serious consideration should be given to pursuit of a multilateral accord.

The difficulty with a multilateral approach is that many other countries are benefitting from the strong dollar which makes foreign goods more price competitive and has resulted in a large influx of imported goods into the U.S. Some countries (importers of dollar-denominated oil) may be willing to negotiate but many other countries may not have any real incentive to participate in a multilateral accord. Consequently, the U.S. should also seek *unilateral* action it can take in an effort to moderate the dollar.

Looking now at the contributing factors referenced above, no one would seriously urge action to reduce the safe haven aspect of the United States.

Similarly, no one would suggest action to dampen the current U.S. recovery which has been somewhat Utopian with its accompanying low inflation and good employment growth. Conversely, there is not a lot more the U.S. can do to enhance the recovery in the rest of the world. As it is, we are purchasing an ever increasing amount of goods from abroad, which resulted in a 1984 trade deficit of $123 billion. Even with those purchases, the other economies have not recovered as rapidly as the United States.

Capital inflow into the U.S. might be limited or prohibited in order to reduce the value of the dollar. Such action would be contrary to the general U.S. commitment to open markets and economies. It would also be untimely after our recent success in pressuring the Japanese to open their capital markets in order to raise the value of the yen. Restraints on foreign capital are not the answer for two reasons: it would put significant upward pressure on interest rates and would lead to protectionist action abroad which would further hurt our already suffering exports.

That leaves interest rates as a primary area where U.S. policy has the potential for significant influence on the value of the dollar.

INTEREST RATES

There is widespread agreement that the competition between rapidly increasing, record level federal government borrowing needs and the private credit needs of a growing economy is placing an increasing demand on the nation's savings pool. The result of this competition has been referred to as a "crowding out" phenomenon causing interest rates to go up as fewer dollars are available to meet increasing credit needs. Arthur Levitt, Jr., CEO, American Stock Exchange, has referred to this as a "bidding up" process during the current economic recovery in which our public and private sectors are engaged in a bidding war for finite credit resources.

However, as long as the growth potential of the U.S. is perceived as greater than that of our trading partners, foreign capital flows into the U.S. to augment our savings pool. A continuing net inflow of foreign capital in search of maximum return helps finance our growing credit needs and eases somewhat the upward pressure on interest rates.

Would a greater influx of foreign capital be helpful in pushing interest rates down? Perhaps it would, but with the already open market/economy policy of the U.S., there probably are no actions we could realistically take to increase foreign investment. Even if we could induce more investment, it would raise nationalistic concerns about undue foreign ownership in this country. More importantly, it would also cause the dollar to increase in value and further exacerbate our basic problem.

The growing U.S. economy is driving the increase in private sector credit needs -- one of the ingredients in the interest rate bidding war. No one wants to dampen the current U.S. recovery nor should we attempt to do so. Assuming we did choose to slow the recovery, the only effective way is to tighten the credit market which, in turn, would drive up interest rates!

Another approach which the U.S. might take in an effort to drive down interest rates would be for the Federal Reserve to embark on a policy of greater monetary growth. Paul A. Volcker, Chairman, Federal Reserve Board, has acknowledged repeatedly that interest rates are too high for the long-term health of the U.S. or the world economy. But attempts to accomplish the desired goal by excessive monetary growth would provide only very short lived relief at best and would soon lead to inflation. Depreciation of the dollar by inflationary policies would have an adverse impact on our current economic recovery.

Volcker's view is that the greatest contribution the Federal Reserve can make to lasting prosperity lies not in increasing monetary growth but in fostering the expectation, as well as the reality, that we can sustain the hard-won gains against inflation. His position is that as we maintain progress against inflation, interest rates should decline.

FEDERAL DEFICIT

The only remaining part of the interest rate equation to be examined is federal government borrowing. In 1984, the outstanding federal borrowing (excluding tax-exempt notes and bonds) was nearly 48% of the total net demand for credit. Those federal borrowing needs were driven by our record high and growing federal deficit of over $200 billion for 1984. Thus, the federal deficit appears to be the most significant point of attack on the problem of interest rates, which in turn relate to the value of the dollar. The deficit (unlike exchange rates) is the one area in which the U.S. could take prompt, unilateral action.

CONCLUSION

Our first priority should be to deal with the mounting federal deficit. There should be a reasonable level of balance and fairness to any approach to deficit reduction but any attempt to close the gap between federal spending and revenue should first be directed toward the spending side. There should be few if any "sacred cows", and all areas of spending should be reviewed for possible modifications, including defense and assistance programs. Careful attention should also be given to the various cost cutting measures proposed by the Grace Commission.

Tax increases in an effort to raise revenue to the level of federal spending cannot be a preferred solution. Increased taxes reduce the earnings remaining to go into the nation's savings pool. A smaller savings pool available to meet growing credit demands would lead to higher interest rates. However, if a large deficit still remains after adopting all rational spending reductions and cost cutting measures, then and only then should attention be given to a balanced effort to increase revenues.

Exchange rates, in part, reflect a mix of fiscal and monetary policy. Thus, a more restrictive fiscal policy (in the form of significant spending restraint) may require modest relaxation of monetary policy in order to thread the eye of the needle heading to termination/reduction of the dollar's rise without also increasing inflation or dampening economic recovery.

A secondary objective should be to work with our trading partners to review and possibly modify the operation of the floating exchange rate system, or to determine what possibilities exist for greater coordination of action in fiscal and monetary policies. Such efforts could, over time, create a world economic interaction which might moderate the dramatic swings in value of various currencies and avoid future occurrences of the present problem with the dollar or with other currencies.

# # #

ATTACHMENT F

A Letter To Kodak Shareowners

Since the summer of 1980, the U.S. dollar has risen in value an unprecedented 80 percent or more against major worldwide currencies. While this economic trend has been attractive to Americans who travel abroad or choose to purchase imported goods, it has had a decidedly negative effect on U.S. manufacturing companies.

The strong dollar has resulted in a decrease of several percentage points in U.S. economic growth, helped to produce a trade deficit of $123 billion in 1984 and, according to some, eliminated more than 2 million manufacturing jobs. At Kodak alone, some 20,000 jobs depend upon exports.

Impact of the Dollar

Kodak, as a multinational company with about 40 percent of its sales outside the U.S., has not escaped the impact of the artificially strong dollar.

It affects us in several ways:

(1) importers can lower prices of goods they sell in this country because such goods have been made at a cost denominated in cheaper local currencies; thus, importers can "buy" market share without sacrificing profits;

(2) or such importers can increase their profitability by holding prices level and then converting the dollars from U.S. sales to the home currency at advantageous rates of exchange;

(3) since about half of Kodak's sales abroad are based on goods manufactured in the United States, our products become more expensive in other lands, making them less attractive in world markets; and

(4) finally, since Kodak results are reported in dollars, the company must earn more local currency to make the equivalent amount of U.S. dollars, thus depressing sales and the consequent earnings.

The Cumulative Effect

In 1984, Kodak net earnings totaled $923 million, an increase of 63 percent over the depressed levels of 1983. Earnings per share reached $5.71—up from $3.41 in 1983. Yet the upward surge of the dollar actually *reduced* our earnings by about $.60 a share in 1984 alone. If the dollar remains at its current value, 1985 earnings will be adversely affected by more than they were in 1984.

During the past four years the strengthening dollar has reduced the company's earnings by a cumulative $3.25 a share, or by more than $500 million. Even that amount understates the case, as it fails to account for earnings lost due to dollar-related adverse competitive conditions at home and abroad. Altogether, Kodak earnings may have been reduced since 1980 by at least $1 billion because of the dollar's strength.

This challenge is affecting all U.S. companies operating in global terms. Kodak believes in free trade; we do not advocate protective tariffs and import quotas. But while the company welcomes fair competition in a healthy worldwide marketplace, the abnormally strong dollar encourages imports while restricting the ability of U.S. producers to market their goods and services at home and abroad. In effect, this abnormality provides our competitors with an *unearned* opportunity.

Dedicated to Growth

Kodak is deeply committed to its businesses. The company has budgeted $1,517 million for capital improvements in 1985, with 80 percent of this amount allocated to investments in the U.S. Last year, we spent more than $800 million on research and development, again mostly in this country. In short, we are taking large steps to modernize and improve our plants, to increase productivity, and to innovate for the future. Yet we continue to experience the dollar's record-shattering march on other currencies of the world, in a way that restricts earnings and, for shareowners, the dividends those earnings yield.

Kodak does not believe the issue of the dollar's strength lends itself to simple solutions, as the causes for it are numerous, complex and interwoven. Due to the gravity of this problem, however, we are urging the government to take action on this issue.

Contributing Factors

While low inflation and a strong U.S. economic recovery have contributed to the dollar's strength, high interest rates and the huge federal deficit have worked to compound the problem.

Many believe that the deficit is the other crucial economic problem facing the nation today. Over the past 10 years, that annual deficit has increased from $6 billion to $185 billion, or from less than one percent to nearly five percent of the U.S. Gross National Product. Financing this deficit fuels real interest rates, which are already high by historical standards and generally higher than rates of return available elsewhere.

Borrowing made necessary by the public debt contributes to high interest rates, which contribute, in turn, to the continued strengthening of the dollar—beyond what economic realities would suggest.

A Time for Action

Kodak believes the nation will mortgage its future unless a vigorous attack on the federal deficit is mounted and, further, that this deficit—with its consequences for the dollar—threatens the future vitality of American industry. The rapid compounding of interest on the federal debt makes this a problem of top priority. In two Presidential elections, Americans have rejected tax increases and indicated their desire to limit the size of government. Congress should now address the need for the necessary spending restraints.

In our judgment, the strong dollar and the deficit are the two most critical economic issues facing the nation today. We have made our position on these bipartisan matters clear to representatives of government, and we will continue to voice our strong concerns. We urge Kodak shareowners to do the same.

Colby H Chandler

Colby H. Chandler
Chairman and Chief Executive Officer

Kay R. Whitmore
President

Chairman LaFalce. Thank you very much, Mr. Smith. We appreciate your comments.

We will next hear from academia, Prof. Ronald I. McKinnon of Stanford University.

Mr. McKinnon.

STATEMENT OF PROF. RONALD I. McKINNON, DEPARTMENT OF ECONOMICS, STANFORD UNIVERSITY, STANFORD, CA

Mr. McKinnon. Thank you, Mr. Chairman.

I have a full paper, which I am not going to try and reproduce, which will simply be submitted for the record. I will try and summarize it in my oral comments.

Essentially, the paper, "What To Do About the Overvalued Dollar," tries to deal with the problem that Mr. Smith so eloquently outlined.

As I see it, it is a case basically for reorienting American monetary policy toward the exchange rate, and this reorientation would have——

Chairman LaFalce. This is a little bit off base, and perhaps I am a lone voice in Congress, but I really felt strongly that we should have taken the French up on their demand for parallel talks on our international monetary problems of exchange rates and misalignments. Now I may not have offered it for the more pure of reasons, and agriculture may have been on their minds.

But what were your thoughts about that, Mr. McKinnon?

Mr. McKinnon. Well, the French like to emphasize the idea of an exchange rate agreement without discussing the monetary basis for that agreement, Mr. Chairman.

I think my emphasis would be that we start off by talking about monetary harmonization among the European bloc, the United States and Japan, and if we can get the central banks to agree, then we can evolve toward stable exchange rates.

Chairman LaFalce. Well, they were talking about a conference on international monetary policy as I understood it.

Mr. McKinnon. That is right, but they——

Chairman LaFalce. And that could be all embracing.

Mr. McKinnon. That is true, and if it took the form of getting the central banks to cooperate, I would be delighted. Often it takes the form of a debate as to who is responsible for intervening in the foreign exchange market. I think intervention without the basic monetary cooperation is destined to fail, as we have seen. There has been massive exchange intervention without monetary coordination and it hasn't worked.

Chairman LaFalce. Let's get on with our testimony and then we will revisit that question. I want to spend some time on it.

Mr. McKinnon. All right. That was a good interjection.

As I see it, there is a need for a one-time realignment of the dollar. If you think of the dollar being now between 3 and 3.2 deutsche marks, and it varies daily by huge amounts, my purchasing power parity calculation would put it closer to 2.2 deutsche marks. So from that basis the dollar is 40 to 50 percent overvalued.

Similarly, against the yen where the dollar is now valued at 250 yen, my rough calculation would place it closer to 210. Somewhat strangely, the yen is not undervalued as much as the bloc of European currencies.

So there is a need for this one-time realignment, but I do not think we could stop there. You can't simply have an agreement of that form. What we need is some ongoing agreement to stabilize rates once the realignment has occurred so that speculators will understand that the rates are going to be stable henceforth which will, of course, help promote the realignment to begin with.

Chairman **LaFalce**. How do you get this one-time realignment?

Mr. **McKinnon**. How do you do it?

Chairman **LaFalce**. How do you bring it about?

What would be the dislocated effects of that, if any?

Mr. **McKinnon**. I hope to get to that, Mr. Chairman.

We have discussed fiscal policy in some detail, and I think we have to separate out the trade deficit itself from the currency misalignment. The huge U.S. fiscal deficit that we have would create a large trade deficit at any exchange rate. Even if we had purchasing power parity exchange rates, we allowed this huge fiscal deficit to develop which raises our expenditures above our income, and that will spill over into foreign trade.

So even if we had been under the old Bretton Woods system of fixed nominal rates, a fiscal deficit of this huge magnitude would cause a trade deficit to develop

So I am very sympathetic with all the commentators who wanted to correct the fiscal deficit to correct the trade deficit. But I think it is important to realize that that will not necessarily secure the exchange rate system and that we still need the coordination in monetary policy to properly secure the exchange rate system. On this, I think, Assistant Secretary Johnson had a point.

If the U.S. Government suddenly announced that in fact we have a $200 billion deficit problem and not just $50 million that we are discussing and then moved to deal with that in both the expenditure and tax side, it is not clear to me which way the dollar would move in the foreign exchange markets.

It is certainly true that U.S. interest rates would come down, but because a lot of the pressure in the market has been a safe haven pressure concern for political safety and the tax reasons that Assistant Secretary Johnson mentioned, the fact that the Greens may have the balance of power in Germany, all of these things have created a safe haven effect in the United States. Therefore, fiscal policy is a very blunt instrument, and it is not terribly predictable even though it would be very wise to bring it under control.

Now to suggest that the dollar has been very strong for these political, economic, safe haven reasons——

Chairman **LaFalce**. This portion of the hearing had better not be made public. Individuals will go out and say we need a bigger deficit so we won't have such a safe haven. [Laughter.]

Mr. **McKinnon**. Well, when we had a very weak dollar in the 1970's, we certainly didn't have a fiscal surplus, did we, Mr. Chairman? We have a very strong dollar now with the deficit, but the link between fiscal policy and the strength of the currency isn't clearcut. That is the main point I want to make. Whereas we can harness monetary policy in a very definite way to stabilize the exchange rate system, and that is what we did under Bretton Woods——

Chairman LAFALCE. Are you talking about domestic or international or both?

Mr. MCKINNON. No, both. The point that Mr. Johnson made about the safe haven effect is correct. That is the reason for the strong dollar, but that doesn't mean that central banks should not react to that. If there is a shift away from deutsche mark assets into dollar assets because of the safe haven effect, in my view, this is a signal that the Bundesbank should follow a fairly restrictive monetary policy because the demand for deutsche marks has fallen and the Fed should be following a much more expansive monetary policy because the derived demand for base money in the United States has risen.

So these shifts in international portfolio preferences, although they are inevitable, do not mean that the central banks should stand idly by. The central banks can react to them and in so doing stabilize the exchange rate system.

Now how they should react more precisely is the basis of my presentation.

Under the old fixed exchange rate system of the 1950's and 1960's, central banks other than the American one did all the reacting for the most part. When the yen fixed at 360 to the dollar from 1950 to 1970, every time the Japanese had an incipient balance-of-payments surplus, they simply expanded their money supply and any time they had incipient deficit they contracted. This was the monetary basis for maintaining the rate fix.

Each European central bank more or less followed a similar policy of subordinating its monetary policy to the fixed exchange rate regime.

The one exception to this subordination principal was the United States. The United States was the center country in the system and presumed to have more autonomy than the others in the conduct of its own monetary policy. This autonomy was sometimes called benign neglect, whereas the United States followed its own monetary principles of trying to stabilized the value of the dollar using domestic indicators and ignoring the exchange. The other countries pegged themselves to the dollar and the system overall was stable given these circumstances.

But the flaw in the old Bretton Woods system as applied to the present time is that the United States no longer has the autonomy in world financial and trade markets now as it did then. The United States is much more integrated in foreign trade. There are rival moneys in Europe and now in Japan. So there are continual massive portfolio shifts out of dollar assets into foreign assets and back again.

This tends to destabilize the effective demand for base money in the United States, thus making it impossible for the United States now to follow an autonomous money policy successfully.

So what we want to do in the new system, if we could reconstitute something like the old Bretton Woods stable exchange rate, given their one-time devaluation of the dollar to go with it, is that the Fed must now behave more symmetrically with respect to the other central banks.

So as of the present time when the dollar is unduly strong, the Fed should very consciously react by raising money growth above its longrun norm. If it thinks the longrun norm is 5 percent, it can be increasingly substantially faster.

I agree with Mr. Johnson, the Fed made a bad mistake in 1984 by slowing down too much, but at the same time the central bank whose currency is under pressure, the European central banks or the Bank of Japan, should contract or at least stand fast if the Fed expanded. Of course, if everyone expands together, the dollar exchange rate won't change.

But what we need is this sort of symmetrical reciprocity that the strong currency country has an expansive monetary policy and a weak currency country has a relatively contractionary monetary policy. This keeps the monetary base——

Chairman LaFalce. Has there ever been a time when we have been able to get the central banks to act with such harmony and symmetry acting on the basis of international motives as opposed to national motives?

Mr. McKinnon. Well, the Bretton Woods system was an example, Mr. Chairman, except for the United States. Now I think you don't have to separate out the international from the domestic——

Chairman LaFalce. That was because of the dominance of the United States at that time.

Mr. McKinnon. Right, and the United States was known to be stable and therefore something you would want to peg your money to, which is not necessarily true at the present time.

But I don't think there is this conflict between the needs of the international——

Chairman LaFalce. Our dominance has diminished. Our inclination to harmonize might be greater, but I am wondering if the inclination of our allies would be less?

Mr. McKinnon. Well, it has traditionally been true in Europe that central banks have paid much more attention to the exchange rate in the 1970's and early 1980's than say the United States. You can look at the pattern of their currencies and you can associate that pattern with their monetary expansiveness.

For example, when the deutsche mark was extremely strong in 1978 and 1979, the German money growth was extremely high on the order of 12 or 13 percent a year. The German central bank was reacting to the state of the foreign exchange markets.

The one central bank in the system that doesn't systematically react is the Fed, and I think that has to be the basis for the new agreement, and it is in America's own interest. It is not as if we are giving up something in order to secure international harmony.

First of all, the free trade system, if we are to preserve it with a stable monetary standard, is very much in the American national interest.

Second, you can demonstrate, and I spent a whole book trying to demonstrate it, but I won't go through it here, that if the Fed had used the dollar exchange rate as the leading indicator on which to base its monetary policy so when the dollar tended to be weak the Fed contracted and when the dollar tended to be strong the Fed expanded, the American business cycle over the last 12 or 13 years would have been much smoother. It wouldn't have had the great inflation of the 1970's nor the sudden deflation of the early 1980's.

So there is no internal sacrifice that one has to make in order to go back to a fixed rate system, no net sacrifice. There might be uncertain specific circumstances.

The most recent example of this was the great rise of the dollar in 1984 and early 1985. That was a very clear signal to the Fed that it was being too tight. If the international demand for dollars is greater than anticipated you should loosen up and respond to that demand. The Fed really didn't until very early this year and did so in an ambiguous way, as I argue in my paper.

By failing to heed the tight money situation which the exchange rate was signaling, the Fed left us with a very weak economy in 1985.

Chairman LaFalce. Mr. McKinnon, let's suppose that whether just by spending cuts or by increased revenues that we reduce our deficit from whatever it is projected to be, $220 billion or $230 billion, and I think we have new economic assumptions now. For example, GNP is not increasing as much as it was, and that might increase the deficit, and maybe there are other economic assumptions of the change that decrease it. But of what meaning is a $50 billion reduction in the deficit on the overvalued dollar in comparison with the effect we might have by a more liberalized monetary policy?

Mr. McKinnon. Well, as I mentioned, I think the fiscal effect is ambiguous. I agree with Mr. Johnson at this point that safe haven effects are quite dominant in international investor decisions. People realize that the huge fiscal deficit is unsustainable and they project that into the future and then they get nervous at least in the distant future about holding assets in the United States, not in the near term.

Now if we do something to correct the fiscal deficit so it means in the distant future the United States looks like a safer place, then the safe haven effect could actually overwhelm the effect of lower interest rates which the reduced deficit would give us.

So there is this basic ambiguity regarding the deficit and the interest rate. I am not saying that we shouldn't deal with the deficit. It is extremely important. I am just saying the results will be somewhat ambiguous. We still need the monetary cooperation even if we get the fiscal improvement.

In my paper there are really simply four aspects to the monetary system, sort of the revised Bretton Woods, which I believe could work.

The first is to simply post target zones for exchange rates. If you did a purchasing power parity calculation, the target zone for the dollar against the European bloc would be between 2.1 and 2.3 deutsche marks. This target zone would be soft meaning that we are not going to get there overnight. We would just post that so the markets would know that is what we are aiming for and then we would have this mutual monetary adjustment as long as the dollar remained above its zone. The Fed would be expansionary and the Bundesbank would not be expansionary.

We would have direct intervention only when the markets were disorderly, say a sharp movement away from the purchasing power parity rate. But foreign exchange intervention in itself——

Chairman LAFALCE. You produced this book under the auspices of the International Institute for Economics, right?

Mr. MCKINNON. Yes.

Chairman LAFALCE. Is there general agreement within the institute on these principles? I know Fred Bergsten agrees.

Mr. MCKINNON. Well, actually there is an agreement on the great importance of monetary policy and the ability of monetary policy to influence exchange rates. There is disagreement on whether or not the correction of the fiscal deficit would be ambiguous. See, I wrote this book more or less ignoring fiscal policy, and everyone else said well, I should put it in, and that would be the area of disagreement.

Chairman LAFALCE. But, you see, there is ambiguity, and what kind of ambiguity. Clearly there are those who say, yes, reducing the deficit is going to have a good effect on the problem of the overvalued dollar. Are there those who say definitely it is going to have a bad effect?

Mr. MCKINNON. No. Some people like me say that the fiscal deficit is ambiguous in its effect on the exchange rate. But it is not ambiguous in its effect on the trade deficit. For any exchange rate system we have, if you bring down the fiscal deficit, you will bring down the trade deficit.

Chairman LAFALCE. Can you explain that a bit more? How does it impact the trade deficit without the link of the overvalued dollar first?

Mr. MCKINNON. Well, if you imagined that the United States was a somewhat smaller more open economy so that all of the goods produced and consumed here were what are called tradeable goods, their value was determined in world markets. Then the government of this small economy suddenly embarks on a program of raising expenditures above current output. The expenditures would spill over——

Chairman LAFALCE. What are you talking about output, revenues?

Mr. MCKINNON. Yes. The effect of the fiscal deficit is to raise expenditures for the economy, including the Government's expenditures, above current output.

Chairman LAFALCE. Above current revenues.

Mr. MCKINNON. Well, by the Government raising expenditures above revenues in a big way, this forces the economy to raise its absorption above its current output, and the difference is the trade deficit.

Chairman LAFALCE. OK, but the expenditures have really not increased above past expenditures being the preceding year, the preceding year and the preceding year.

Mr. MCKINNON. Well, you see, by reducing taxes we encourage the private sector to raise its expenditures, and it is just sort of a bookkeeping matter that you can show that the difference between total output GNP and domestic absorption or expenditures is equal to the gap between saving and investment. The Government's fiscal deficit is a very important element in that gap.

Chairman LaFalce. Well, we will revisit that afterward.

Mr. McKinnon. OK. If you had a fixed nominal exchange rate in this small open economy and you have a fiscal deficit, you will show up with a trade deficit with no change in exchange rate. But that is a point that is not generally realized by most people here.

We have the immediate problem of getting the dollar down and then it is of course necessary to manage the system into the more distant future. But I would like to return to one point that Representative Reuss raised about the inflationary consequences of this one-time depreciation of the dollar.

When we had the big dollar devaluations of the 1970's, in 1971 and 1973 and again in 1977 through 1979, there was a monetary explosion in the rest of the world from people who have looked at the statistics. You can see that the money supplies of European countries greatly increased in the 1971, 1972, and 1973 period and again in 1977 and 1978. Because they were trying to keep the dollar from depreciating, foreign central banks intervened by buying dollars and selling their own currencies. So there was a monetary explosion in the rest of the world.

Therefore, those dollar depreciations were associated with a great deal of international inflation.

Now if we have the kind of agreement that I have in mind here where are going to nudge the dollar down to 2.2 deutsche marks, the important element in that agreement is that the other central banks sit on their money supplies and they don't expand as they did in the 1970's.

Now if we have that agreement, then we can get the one-time depreciation without the mass of inflationary consequences that we experienced in the 1970's.

Thank you.

[The prepared statement of Prof. Ronald I. McKinnon, entitled "What To Do About the Overvalued Dollar," follows:]

March, 1985

WHAT TO DO ABOUT THE OVERVALUED DOLLAR*

by

Ronald I. McKinnon
Stanford University

Reneging on the long-standing American commitment to maintain free international trade would undermine the economic basis for the postwar prosperity of the noncommunist world. Yet, the grossly overvalued dollar--as much as 40 to 50 percent when measured against European currencies and about 25 percent against the Japanese yen--is imposing undue competitive pressure and great distress across a broad spectrum of American farming, mining and manufacturing activities. And pressure to restrict imports is rapidly increasing.

However, a return to protectionism is no solution at all. Restricting imports entering the United States would drive the dollar up further, causing even more misfortune for American exporters.

But to thwart protectionism, the financial imbalance between the United States and the industrial countries of Western Europe and Japan must be righted. The large U.S. fiscal deficit is commonly (and correctly) blamed for much of the trade deficit--but it cannot explain the present extraordinary exchange-rate misalignment. I hypothesize that monetary coordination among the United States, the European bloc, and Japan is the only practical way of correcting dollar overvaluation while at the same time preserving longer-run price and exchange-rate stability.

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*Much of the empirical and theoretical support for the proposals advanced in this paper can be found in the author's recent book, An International Standard For Monetary Stabilization, the Institute for International Economics, (Washington D.C.) and the M.I.T. Press, 1984. Some of these materials are included in the supporting tables and figures, all of which appear at the end of the paper rather than being inserted into the text.

The Fiscal Conundrum

An obvious target for reform is American fiscal policy. Huge budget deficits, which the Federal Reserve properly refuses to monetize--increase American real interest rates (those calculated after expected future price inflation is discounted) and attract capital from abroad. The dollar is then bid up in the foreign exchange markets--overshooting its long-run equilibrium--as foreigners rush to take advantage of the high yields on U.S. government bonds and corporate securities. Apart from exchange-rate overshooting, however, the trade deficit simply cannot be eliminated while the fiscal deficit remains so large and raises the country's expenditures above its income.

But fiscal policy is not the whole story. After all, the large dollar depreciations of the 1970s were not caused by U.S. budgetary surpluses! Indeed, in the 1970s, some commentators at the time pointed to the much smaller U.S. fiscal deficits as one reason why foreigners felt nervous about holding on to dollar assets.

Moreover, much of the recent increase in the foreign exchange value of the dollar has been associated with falling nominal interest rates. From August 1984 to early February 1985, American interest rates fell 2 to 3 percentage points relative to those in Germany (see Figure 4), while the dollar was rising from 2.88 to 3.25 marks (Figure 2).

Although interest rates remain important, expectations of future political safety, price inflation, and other sources of future exchange rate movements often dominate the portfolio preferences of international investors. The gnomes of Zurich, Luxembourg, and Singapore continually look for the safest haven (currency) in which to place their internationally liquid assets.

Suppose the American government moved seriously towards cutting expenditures. U.S. interest rates would fall immediately in anticipation of lower future fiscal deficits, and this effect by itself would tend to depress the dollar in the foreign exchanges. Against this, people might expect that the resulting reduction in the projected national debt would lessen the chances of price inflation in the distant future. Similarly, other taxes on the holders of dollar assets become less likely. The United States could then seem like an even safer haven for international capital.

Because of these opposing considerations, even resolute action by the American government to eliminate its unsustainable fiscal deficit need not bring the dollar down in the foreign exchange markets--although it probably would. (The one dramatic exception is a general withholding tax on interest and dividend income--including all those American securities owned by foreigners. That certainly would bring the dollar down.) At best, fiscal policy is a blunt instrument, subject to long delays and uncertainties, for influencing the exchange rate.

Enter Monetary Policy

In contrast, monetary policy is immediately flexible and can be made to influence the exchange rate unambigously. From the 19th century gold standard to the fixed exchange rates of the 1950s and 1960s under the old Bretton Woods agreement, examples abound of countries successfully subordinating their monetary policies to maintaining a fixed exchange rate with some other stable money. Central banks can react quickly to international shifts in the demand for the money they issue.

In the asymmetrical Bretton Woods system, countries other than the United States were directly responsible for maintaining their exchange rates within one percent of either side of their formal dollar parities. For example, from 1950 to 1970, the Bank of Japan kept the yen within 3/4 of one percent of 360 yen to the dollar by raising yen interest rates and contracting when international payments were in deficit, and expanding the yen money supply when the Japanese currency tended to appreciate. Japanese monetary policy, based on this fixed exchange-rate rule, led to stable yen prices for the broad range of internationally traded goods and contributed to Japan's extraordinary postwar recovery.

Similarly, in these same two prosperous decades, European governments generally subordinated their monetary policies to preserve stable exchange rates for long periods--with small, infrequent adjustments in their dollar parities. Only Britain continually resisted the necessary internationalization of its domestic monetary policy with consequential balance-of-payments deficits and numerous "sterling crises" throughout the 1950s and 1960s. And Britain had the least successful domestic growth and foreign trade performances of any Western European economy.

The Flaw in Bretton Woods

But the Bretton Woods system had an inherent weakness. The monetary policy of the center country, the United States, was insufficiently guided by any exchange-rate or other international obligation of its own. Even the American commitment to a weak form of gold converibility, itself inadequate, had eroded by the late 1960s.

Consequently, in 1970-73, the international system of fixed exchange rates broke down when the United States increased U.S. money growth despite the fact that the dollar was under obvious downward pressure in the foreign exchanges. Mistakenly, in 1971 President Nixon forced the other governments to let the dollar be devalued rather than contract the U.S. money supply. Private investors took this as a signal to reduce their holding of dollar assets in favor of foreign currencies --forcing further depreciations of the dollar in 1972-73, as shown in Figure 1.

The resulting great inflation in the dollar prices of goods and services in the 1970s (Table 2) was aggravated by another unwarranted depreciation of the dollar in 1977-79. Foreign governments became loathe to bend their monetary policies to reestablish fixed dollar parities with what they then saw to be a chronically depreciating international currency.

Responding firmly, albeit belatedly, to domestic price inflation, the U.S. Federal Reserve System tightened up its monetary control procedures in October 1979. But international confidence in the dollar was not restored until the election of a more convervative president in late 1980. The remarkable shift in portfolio preferences back into dollar assets, and the great dollar appreciation of 1981-82, surprised everyone. In response to this clear signal from the foreign exchanges that U.S. monetary policy was now too tight, the Fed did not loosen up soon enough The result was the sharp deflation and depression of 1982.

Although threatening to undermine the American free trade ethic, the overvaluation of the dollar in the early 1980s had one significant advantage. The international concern over chronic American inflation is now largely dissipated. Indeed, Germany, Japan, and the United States now have virtually the same low rate of price inflation (Table 2). Thus 1985 is a good time to negotiate a new agreement for stabilizing exchange rates--at a much lower foreign exchange value for the dollar--while keeping international price inflation close to zero.

For any new exchange-rate agreement to be successful, however, the flaw in the old one must be corrected. In cooperation with other central banks, the U.S. Federal Reserve System must give exchange-rate stability more weight in the future conduct of American monetary policy. Speculative pressure is now too great for Japan or European countries to stabilize dollar exchange rates on their own; many have tried (and failed) to do so in recent years--particularly in the last few turbulent months.

A New Monetary Order for the 1980s

Assume now that in making American monetary policy, the Federal Reserve System abandons its traditional insular approach, which virtually ignores the foreign exchanges. By some miracle, suppose that the Bank of Japan, the Bundesbank (representing the European bloc), and the Fed all agree to coordinate their monetary policies to achieve exchange stability.

How could such a system be efficiently managed to nudge the dollar down in the foreign exchanges without significant inflationary consequences? Once this transition is completed, how can fixed exchange rates and stable prices be maintained?

Announcement effects are as important as the fact of monetary cooperation itself. To harness the market's expectations in favor of the new exchange-rate regime, the three central banks must spell out what they intend to do in a consistent fashion. Only then will the required adjustments in national monetary policies turn out to be minimal.

So what should the triumvirate announce? The new monetary order would have four essential elements:

(1) Explicit target zones for the yen/dollar and mark/dollar exchange rates;

(2) A commitment to adjust domestic monetary policies-symmetically among the three countries--to achieve these targets;

(3) Rules for restrained, but decisive, direct interventions to correct "disorderly conditions" in the foreign exchanges;

(4) Joint management of aggregate money growth within the triumvirate in order to stabilize their common price level in the longer run.

Let us discuss each in turn.

Target Zones For Exchange Rates

Exchange-rate targets would be designed (and announced) to achieve a rough purchasing power parity among the three countries--taking their current stable price levels as benchmarks. Illustrative calculations suggest that about 2.2 marks and 210 yen to the dollar--far under today's market quotations--approximate what the triumvirate should strive for.

The important point is that these exchange-rate targets are designed to align national price levels and not to correct bilateral (or multilateral) trade deficits or surpluses. Even if the dollar were nudged down so that the American price level became better aligned with those of Germany and Japan, the large U.S. fiscal deficit would still leave a large U.S. trade deficit--albeit one that was somewhat smaller.

Because of the current substantial difference in interest rates between the United States and the other two countries, a broad 10 percent band should be established around these two central rates. To illustrate, the dollar could be targeted to stay within a range of 2.10 and 2.30 marks, and within 200 to 220 yen.

In view of the present extreme misalignment of the dollar, these target zones are necessarily "soft". That is, the participating central banks are not committed to achieving them immediately. In particular, any massive official intervention in the foreign exchanges to push rates in the desired direction would be ruled out.

Nevertheless, the targets are real enough. The gnomes would clearly understand the direction in which the central banks were pushing. In view of the misinformation and confusion that now prevails in the exchange markets, a clear official declaration of exchange-rate goals would allow private expectations to coalesce in support--provided that the accompanying program of monetary adjustment was credible.

Mutual Monetary Adjustment

Among the three countries, monetary adjustments would take place symmetrically for as long as the relevant exchange rate was outside its target zone--whether that be weeks, months, or years. When the dollar exchange rate is above its target zone(s), the Fed should expand the money supply and reduce interest rates while the Bundesbank and Bank of Japan contract symmetrically. (And act conversely if the dollar were ever to fall below its target range.)

For example, suppose that the current mark/dollar exchange rate is 3.30, that the Fed's normal long-term annual growth rate for M1 is between 4 and 6 percent, and that the Bundesbank's normal growth in what it calls "central bank" money is also between 4 and 6 percent. Then the Fed would be publicly committed to increasing its money growth above 6 percent (possibly reducing interest rates), while the Bundesbank kept its money growth below 4 percent (possibly raising interest rates), until the mark/dollar rate fell below 2.3 marks and into its target zone.

To be successful in changing traders' expectations to push the mark/dollar exchange rate in the desired direction, this commitment to mutual monetary adjustment must be unambigous. To avoid adverse expectations, other potentially conflicting rules need to be jettisoned.

The surprisingly sharp rise of the dollar from 3.2 to about 3.47 D.M. in February 1985 (Figure 2) was due at least in part to an apparent conflict in the U.S. Federal Reserve System's immediate monetary objectives. In November and again in December 1984, the Fed cut the discount rate and embarked on much faster money growth; it correctly noted that such expansion was warranted because (among other factors) the dollar at 3.0 marks was grossly overvalued even then. And for November, December and January, growth in U.S. M1 spurted to more than 11 percent measured on an annual basis--see Figure 3.

However, in January the Fed then published--as required by the U.S. Congress--its money growth targets for all of 1985. A normal 4 to 7 percent growth range for M1 during 1985 was announced. Unfortunately, this published money growth target now conflicted with the higher money growth actually taking place in early 1985. In February and March, actual M1 was far above the cone of "permissable" levels officially published as shown in Figure 3.

The market came to expect that the Fed would have to contract to get M1 back on its "normal" path. In anticipation, U.S. interest rates rose sharply in February 1985 (Figure 4) and drove the dollar up further in the foreign exchanges. This surge into dollar assets assumed panic proportions when Fed Chairman Volcker, testifying before Congress on

February 20, suggested that the Fed would end the progressively easier credit policy adopted in late 1984.

Clearly the Fed should have made clear that monetary ease would continue indefinitely, and that lower long-term growth in M1 would not be resumed until the dollar had fallen into its target zone.

The credibility of this unusual--if fleeting--attempt by the Fed to key on the exchange rate was further undermined by the absence of any agreement on how foreign central banks would react. Those countries with weak currencies--most particularly the European bloc--should have reduced their money growth below normal when the Fed undertook its unusual expansion in late 1984. Downward pressure on the dollar would then come from both sides.

If, instead, the German and Japanese central banks behaved perversely by expanding in tandem with the Fed, the private markets would have no assurance that the dollar would be successfully pushed down. Not knowing what the other central banks were going to do, private speculators were less likely to support the Fed's actions by anticipating dollar depreciation.

Clearly, monetary adjustments by one central bank are much more likely to succeed in influencing the exchange rate if the market knows that the other two are supporting it. Thus one can see the great value of a formal, well-publicized international agreement on the format for monetary coordination.

Official Intervention in the Foreign Exchanges

The fact, or even the possibility, of direct official intervention in the foreign exchanges captures newspaper headlines. As the American government agonizes over what to do about the exchange rate, the immediate focus is on whether or not the Federal Reserve Bank of New York--in consultation with U.S. Treasury and the Federal Reserve System--should intervene as a buyer or seller of foreign exchange.

On March 8, 1985, the Federal Reserve Bank of New York announced it had intervened to buy Deutsche marks seven times between August and January in relatively modest (for this huge market) amounts of one or two hundred million dollars in each case. The European and Japanese central banks were known to intervene more often, and more heavily, over the same period. As usual, the Fed refused to reveal the details of its more recent--and substantially heavier--interventions in February and early March 1985.

But this emphasis on direct intervention is misplaced, and so is some of the secrecy that veils the precise goals of these interventions.

With the integration of the American, European, and Japanese capital markets, gross stocks of private financial claims on--and liabilities to--foreigners tend to dwarf official exchange reserves. For example, by the end of 1983, private Japanese claims on foreigners were about ten times as high as official exchange reserves; and with the further Japanese financial liberalization in 1984, these gross private claims again increased. In financially open European economies like Germany and Britain, the ratios of gross private claims on foreigners to official exchange reserves are even greater than in the Japanese case.

The upshot is that exchange reserves are too small for direct government intervention to have a significant impact on the huge internationally mobile private holdings of stocks and bonds. Indeed, ample evidence in 1984-85 suggests that official attempts to intervene in the absence of monetary coordination, and without influencing the (adverse) expectations by private traders, did wash out for all practical purposes. For stabilizing the exchange rate, official intervention will be ineffective unless it is accompanied by a supporting monetary policy. And these mutual monetary adjustments--as described above--need not require direct interventions in the foreign exchanges.

That said, there remains a limited role for direct official intervention to correct disorderly conditions in exchange markets over a short period--say, one trading day.

Having posted target zones for exchange rates (according to our hypothetical monetary agreement), the triumvirate of central banks could treat as "disorderly" any substantial exchange-rate movement away from these official targets. For example, if the target is 2.1 to 2.3 DM/dollar, and the market rate suddenly moves from 3.2 to 3.3 or more (a not uncommon occurrence in February 1985), then the market is disorderly: the movement is both large and in the wrong direction.

Indeed, such a perverse movement indicates that private traders are not properly informed of official intentions--or that the official exchange-rate targets lack credibility. To reaffirm the central banks' objective of guiding exchange rates into their targer zones, some stabilizing intervention is warranted.

To be both limited in magnitude and decisive in result, any such intervention should be reinforced by discrete monetary adjustments beyond previous measures. This is most easily accomplished by ensuring that interventions in the foreign exchanges are symmetrically unsterilized in their impact on each country's monetary base.

For example, to prevent the dollar from increasing further, suppose the Bundesbank--in consultation with the Fed--purchases 200 million dollars worth of marks in the open foreign exchange market. They could agree that the Bundesbank would retire half of those marks from circulation while the Fed contracted the American monetary base by 100 million dollars. Consequently, interest rates would likely rise in Germany and fall in the United States, thus helping to drive the dollar down.

This is powerful medicine. If the distribution of monetary base between the two countries is affected, even modest official exchange interventions have great leverage--as private traders will quickly realize.

Need Dollar Depreciation Be Inflationary?

Suppose the dollar exchange rate is reduced from present stratospheric levels into the target zones suggested above. Is it possible to avoid reigniting the kind of rapid price inflation associated with the depreciating dollar of the unhappy 1970s?

Yes, because of the inherent symmetry in the above proposal for monetary coordination. When the Fed expands, the other principal central banks contract below normal growth--and vice versa. The result is no unusual growth in the monetary base for the system as a whole--even as the dollar is pushed down to its purchasing power parity.

The great dollar depreciations of the 1970s were associated with increased monetary growth in the United States coupled with sometimes explosive monetary growth in Europe and Japan--as shown in Table 1. The reason for this loss of monetary control abroad was due to foreign central banks' resisting (not very successfully) having their own currencies appreciate when international portfolio preferences had shifted sharply away from dollar assets. Through direct interventions to buy dollars and sell their own monies, or through equivalent domestic monetary expansions to reduce interest rates, they lost monetary control.[1]

The system went askew in the 1970s because the U.S. Federal Reserve System failed to contract when international demand unexpectedly shifted into foreign currencies at a time when the dollar was not overvalued--at least not by today's standards. Because the principal player, the Fed, was not playing the game correctly, the other central banks were simply overwhelmed.

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[1] For a more complete description of how the international money multiplier works, see R. McKinnon, "Currency Substitution and Instability in the World Dollar Standard," American Economic Review, June 1982, Vol. 72, No. 30.

Accidental or not, the great increase in "world" money growth in the 1970s had a strong inflationary impact on the prices of internationally tradable goods--whether manufactures or primary commodities. And all the major industrial economies experienced this price inflation--particularly those like the United States whose currencies had depreciated relative to the others.

In 1985, however, the situation is quite different. The dollar is truly overvalued by any reasonable standard. The portfolio pressure in the foreign exchanges is strongly in favor of dollar assets--which increases the derived demand for U.S. base money. We are starting from a situation of price stability--indeed, one of undue deflationary pressure in those sectors of the American economy that must compete on world markets.

Thus it is relatively safe to increase monetary expansion in the United States to drive the dollar down--and dangerous not to. But as long as the Fed remains expansionary, the other central banks must agree to maintain tight money during the transitional correction in the dollar exchange rate. Once exchange rates were aligned, the three central banks would, ideally, have have also agreed to manage their joint money supply to stabilize the common price level into the indefinite future[2/] Then private expectations would be favourable, and the unfortunate

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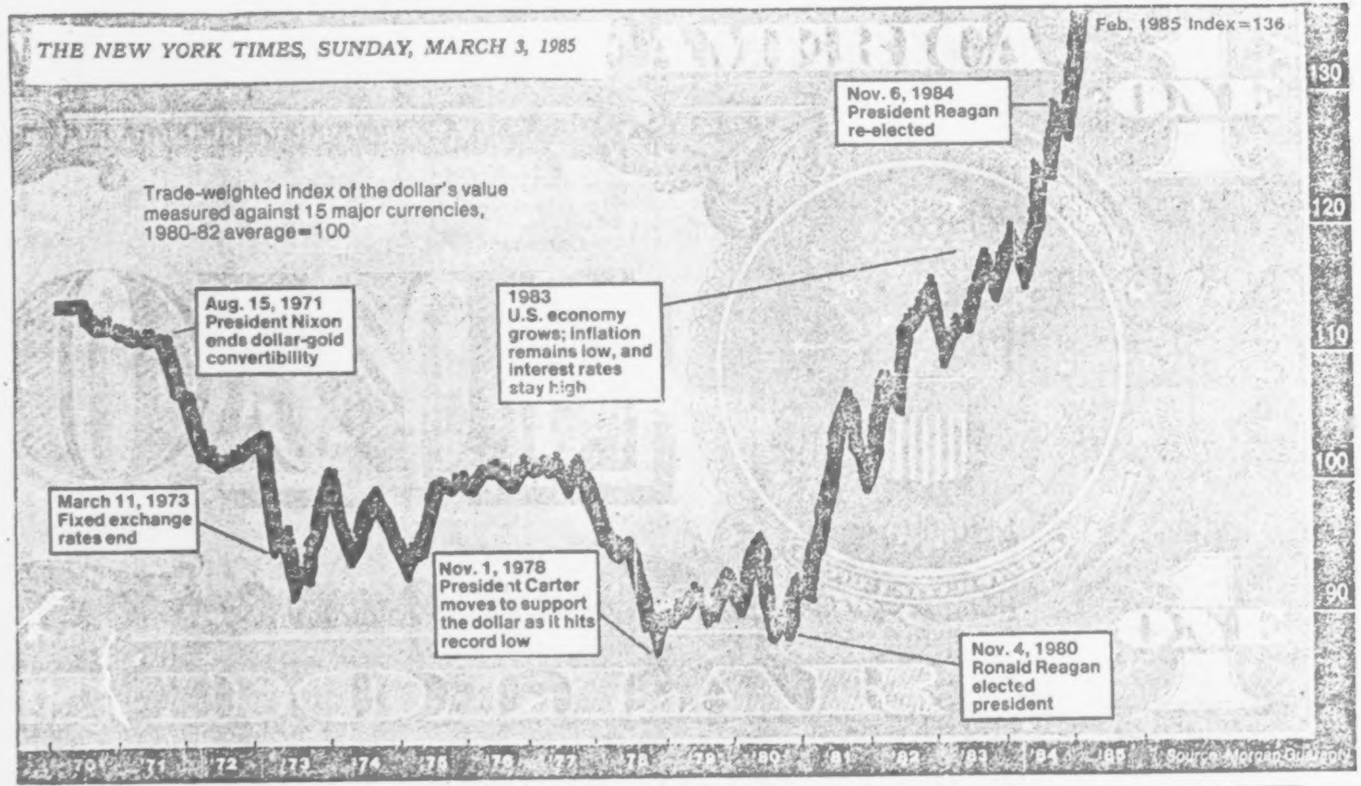
[2/] This paper has not dealt with the precise definition of monetary targets for the three countries which would secure price stability in the longer run. This subject is treated in McKinnon, 1984, Ch. 5. Such a monetary program would avoid sharp changes in the collective money supply while gearing its long-term growth to maintain a stable purchasing power over a common, broad basket of internationally tradable goods.

inflationary experience of the 1970s need not be repeated.

Of course, even if the dollar depreciates under these controlled circumstances, there will be a one time increase in the dollar prices of tradable goods, and a simultaneous decrease in their prices when measured in marks or yen. But this change in relative prices is necessary to rescue unprotected American farmers, manufacturers, and miners from heavy taxation imposed on them by the dollar's overvaluation.

Figure 1

The Dollar Exchange Rate, 1970-85



THE NEW YORK TIMES, SUNDAY, MARCH 3, 1985

Trade-weighted index of the dollar's value measured against 15 major currencies, 1980-82 average=100

Feb. 1985 Index=136

Aug. 15, 1971
President Nixon ends dollar-gold convertibility

March 11, 1973
Fixed exchange rates end

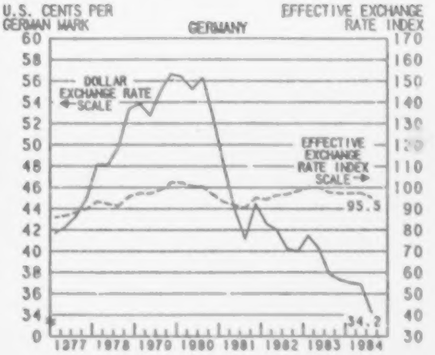
Nov. 1, 1978
President Carter moves to support the dollar as it hits record low

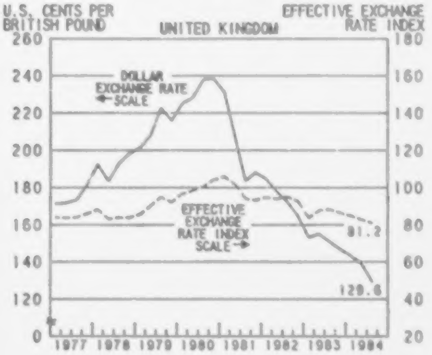
1983
U.S. economy grows; inflation remains low, and interest rates stay high

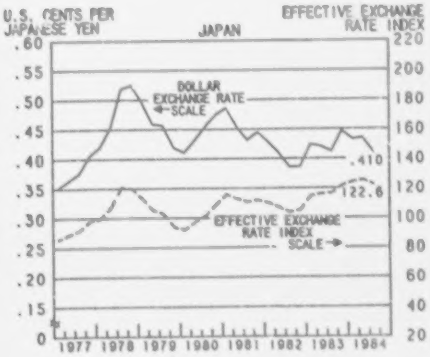
Nov. 4, 1980
Ronald Reagan elected president

Nov. 6, 1984
President Reagan re-elected

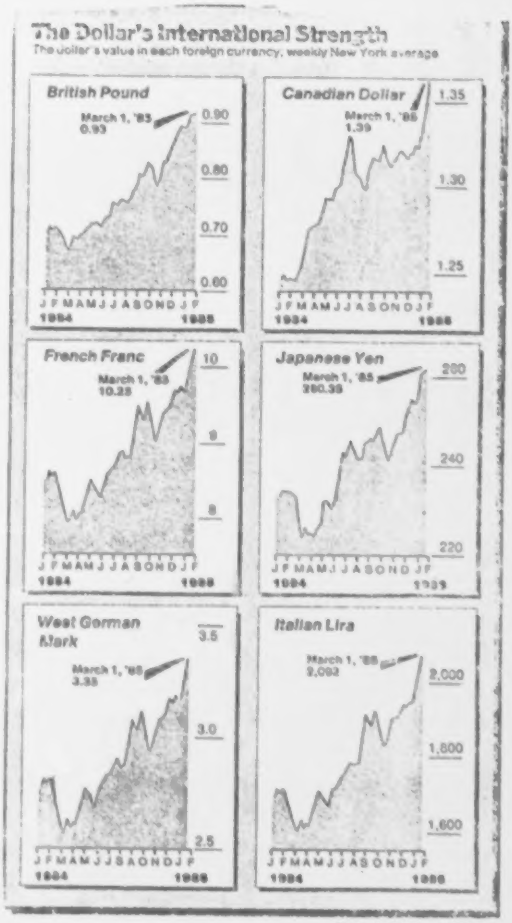
Source: Morgan Guaranty







PREPARED BY FEDERAL RESERVE BANK OF ST. LOUIS
DECEMBER 28, 1984



The New York Times, March 4, 1985

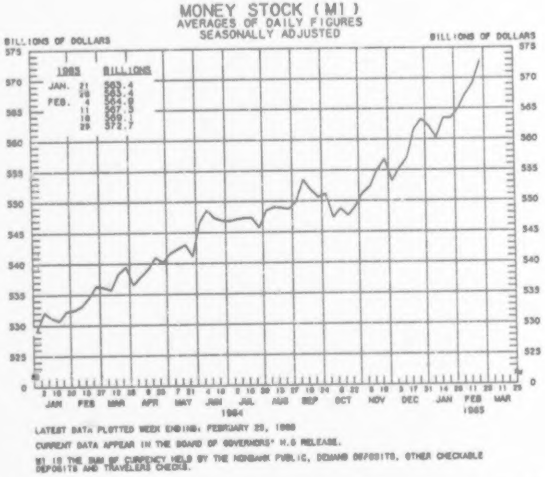
Figure 2

Individual Exchange Rates

Figure 3

U.S. Money Growth and

Federal Reserve Targets



LATEST DATA PLOTTED WEEK ENDING: FEBRUARY 25, 1985

CURRENT DATA APPEAR IN THE BOARD OF GOVERNORS' H.6 RELEASE.

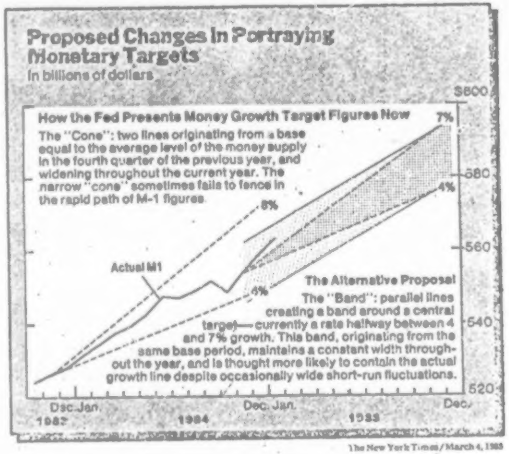
M1 IS THE SUM OF CURRENCY HELD BY THE NONBANK PUBLIC, DEMAND DEPOSITS, OTHER CHECKABLE DEPOSITS AND TRAVELERS CHECKS.

MONEY STOCK (M1)

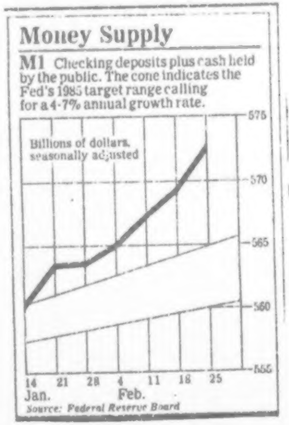
COMPOUNDED ANNUAL RATES OF CHANGE, AVERAGE OF FOUR WEEKS ENDING:

TO THE AVERAGE OF FOUR WEEKS ENDING:	2/27/84	5/28/84	7/23/84	8/27/84	9/24/84	10/22/84	11/26/84	12/24/84
7/23/84	6.2							
8/27/84	5.6	5.1						
9/24/84	5.7	5.4	4.8					
10/22/84	4.2	3.1	1.2	-0.1				
11/26/84	5.0	4.4	3.6	3.7	2.5			
12/24/84	5.1	4.8	4.2	4.5	4.0	6.8		
1/28/85	5.8	5.6	5.4	5.9	5.8	9.5	9.2	
2/25/85	6.5	6.6	6.8	7.3	7.5	10.8	11.0	12.8

PREPARED BY FEDERAL RESERVE BANK OF ST. LOUIS



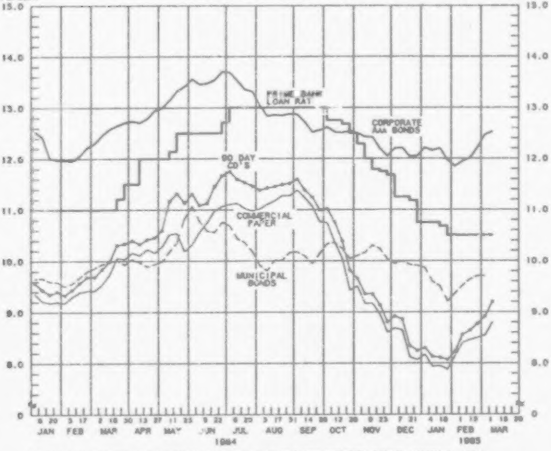
The New York Times/March 4, 1985



Source: Federal Reserve Board

Figure 4

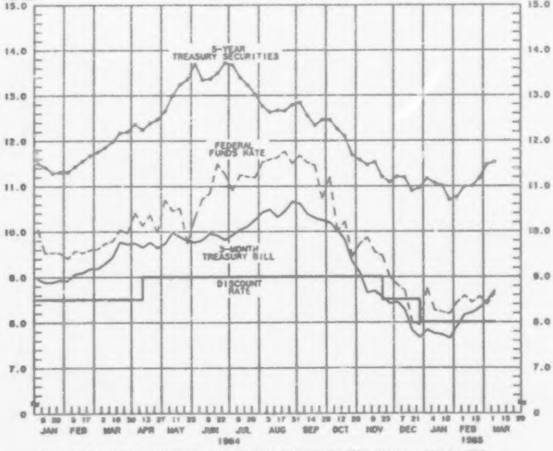
U.S. Interest Rates and the Dollar Exchange Rate



YIELDS ON SELECTED SECURITIES

AVERAGES OF DAILY RATES

LATEST DATA PLOTTED ARE AVERAGES OF RATES AVAILABLE FOR THE WEEK ENDING: MARCH 8, 1985.

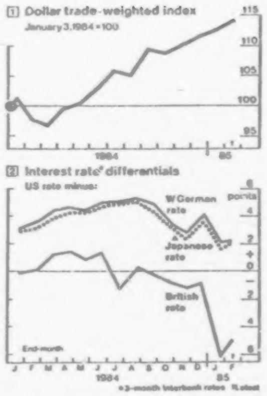


SELECTED INTEREST RATES

AVERAGES OF DAILY RATES

LATEST DATA PLOTTED ARE AVERAGES OF RATES AVAILABLE FOR THE WEEK ENDING: MARCH 8, 1985.

PREPARED BY FEDERAL RESERVE BANK OF ST. LOUIS



1 Dollar trade-weighted index

January 3, 1984 = 100

2 Interest rate* differentials

US rate minus:

*3-month interbank rates †Latest

THE ECONOMIST FEBRUARY 9, 1985

Table 1

Money growth in domestic currencies, 11 industrial countries
(percentage change in annual averages of M1)

	Belgium	*Canada*	*France*	*Germany*	*Italy*	*Japan*	*Nether-lands*	*Sweden*	*Switzer-land*	*United Kingdom*	*United States*	*World average*	*Rest of world*[a]
(Weights: GNP 1964)	(.0132)	(.0394)	(.0778)	(.0892)	(.0494)	(.0681)	(.0144)	(.0167)	(.0113)	(.0796)	(.5408)		
1956	2.9	−1.2	10.3	7.2	8.5	16.4	−3.7	7.4	6.0	1.0	1.1	3.78	6.94
1957	−0.1	4.0	8.6	12.1	6.3	4.1	−2.0	3.4	1.8	2.7	−0.6	2.43	6.01
1958	5.8	12.8	6.4	13.1	9.9	12.8	11.9	1.6	9.2	3.0	4.3	6.47	9.04
1959	3.2	−3.2	11.4	11.8	14.0	16.5	4.5	18.0	6.1	4.6	0.1	4.53	9.74
1960	1.9	5.1	13.0	6.8	13.5	19.1	6.7	−1.2	10.2	−0.8	−0.4	3.72	8.58
1961	7.7	12.4	15.5	14.8	15.7	19.0	7.7	10.7	8.1	3.2	2.9	7.39	12.68
1962	7.2	3.3	18.1	6.6	18.6	17.1	7.5	5.6	16.6	4.4	2.1	6.18	10.99
1963	9.8	5.9	16.7	7.4	16.9	26.3	9.8	8.1	8.9	0.3	2.8	6.86	11.65
1964	5.6	5.1	10.3	8.3	6.7	16.8	8.5	7.7	0.2	5.0	4.1	6.16	8.59
1965	7.4	6.3	9.0	8.9	13.4	16.8	10.9	6.4	12.8	2.7	4.3	6.59	9.30
1966	6.7	7.0	8.9	4.5	15.1	16.3	7.2	9.9	3.1	2.6	4.6	6.31	8.33
1967	4.7	9.5	6.2	3.3	13.6	13.4	7.0	9.8	6.0	3.2	3.9	5.49	7.37
1968	6.8	4.4	5.5	7.6	13.4	14.6	8.8	−1.8	11.5	6.0	7.0	7.51	8.12
1969	2.3	6.9	6.1	8.2	15.0	18.4	9.4	2.0	9.5	0.4	5.9	7.00	8.30
1970	−2.5	2.4	−1.3	6.4	21.7	18.3	10.6	7.3	9.8	6.4	3.8	5.80	8.15
(Weights: GNP 1977)	(.0172)	(.0487)	(.0885)	(.1122)	(.0471)	(.1404)	(.0228)	(.0195)	(.0148)	(.0572)	(.4316)		
1971	10.3	12.7	13.7	12.0	22.9	25.5	16.7	9.0	18.2	11.8	6.8	12.45	16.74
1972	15.0	14.3	13.0	13.6	18.0	22.0	17.7	11.8	13.4	13.1	7.1	12.21	16.10
1973	9.8	14.5	9.9	5.8	21.1	26.2	7.4	9.6	−1.0	8.6	7.3	11.06	13.91
1974	6.8	9.3	12.6	6.0	16.6	13.1	3.1	16.3	−1.7	4.8	5.0	7.78	9.88
1975	12.4	13.8	9.9	13.8	8.3	10.3	18.7	15.2	2.4	15.6	4.7	8.83	11.96
1976	9.6	8.0	15.0	10.4	20.5	14.2	11.8	14.0	7.3	13.8	5.7	9.91	13.10
1977	8.0	8.4	7.5	8.3	19.8	7.0	14.3	8.3	4.7	14.4	7.6	8.72	9.57
1978	6.7	10.0	11.2	13.4	23.7	10.8	5.3	13.6	12.7	20.1	8.2	10.99	13.11
1979	3.5	6.9	12.2	7.4	23.9	9.9	2.7	12.7	7.8	11.5	7.7	9.23	10.39
1980	−0.2	6.3	8.0	2.4	15.9	0.8	4.2	21.1	−5.4	4.9	6.2	5.53	5.01
1981	3.6	4.3	12.3	1.2	11.1	3.7	2.6	12.0	−0.9	10.[illegible]	7.2	6.50	5.96
1982	3.4	2.0	14.9	3.5	9.9	7.1	4.9	9.8	3.1	8.3	6.5	6.96	7.31
1983	5.0	10.2	12.1	10.3	17.3	3.0	10.6	11.4[b]	7.6	13.4	11.1	10.1	9.48

—Not available.

Source: Federal Reserve Bank of St. Louis, "International Economic Conditions," June and August 1983.

a. United States excluded.

b. Preliminary data.

Table 2

Price inflation in tradable goods, 11 industrial countries
(percentage change in annual averages of WPIs)

(Continued)

	Belgium	*Canada*	*France*	*Germany*	*Italy*	*Japan*	*Netherlands*	*Sweden*	*Switzerland*	*United Kingdom*	*United States*	*World average*	*Rest of world*[a]
(Weights: GNP 1964)	(.0132)	(.0394)	(.0778)	(.0892)	(.0494)	(.0681)	(.0144)	(.0167)	(.0113)	(.0796)	(.5408)		
1958	−4.4	0.4	5.1	−0.5	−1.7	−6.5	−1.3	4.3	−3.2	0.8	1.5	0.68	−0.30
1959	−0.3	0.8	7.2	−0.8	−2.9	0.9	0.2	0.9	−1.6	0.3	0.2	0.57	1.00
1960	1.2	0.2	3.5	1.3	0.8	1.1	0.0	4.1	0.6	1.3	0.2	0.81	1.54
1961	−0.2	0.2	3.0	1.5	0.0	1.1	−0.2	2.2	0.2	2.6	−0.4	0.47	1.50
1962	0.8	1.1	0.6	0.9	3.2	−1.6	0.3	4.7	3.3	2.3	0.2	0.64	1.16
1963	2.5	1.3	2.9	0.5	5.3	1.6	2.4	2.9	3.9	1.0	−0.4	0.72	2.03
1964	4.7	0.9	3.5	1.0	3.0	0.4	6.1	3.4	1.3	3.1	0.2	1.15	2.27
1965	1.1	1.3	0.7	2.5	1.8	0.7	3.0	5.2	0.6	3.5	2.0	1.98	1.95
1966	2.1	2.9	2.8	1.7	1.5	2.4	5.0	6.4	1.9	2.9	3.4	3.02	2.57
1967	−0.9	1.9	−0.9	−1.0	−0.2	1.7	1.0	4.3	0.3	3.1	0.2	0.45	0.75
1968	0.2	2.2	−1.7	−0.7	0.6	1.0	1.9	2.0	0.1	4.1	2.4	1.68	0.83
1969	5.0	3.7	10.7	1.9	3.6	2.0	−2.5	3.5	2.8	3.7	3.9	3.99	4.09
1970	4.7	2.4	7.5	5.0	7.4	3.7	4.6	6.8	4.2	7.1	3.6	4.54	5.65
(Weights: GNP 1977)	(.0172)	(.0487)	(.0885)	(.1122)	(.0471)	(.1404)	(.0228)	(.0195)	(.0148)	(.0572)	(.4316)		
1971	−0.5	2.0	2.1	4.3	3.3	−0.8	4.5	3.2	2.1	9.1	3.3	2.94	2.67
1972	4.0	4.3	4.7	2.5	4.1	0.8	5.1	4.6	3.6	5.3	4.4	3.74	3.24
1973	12.4	11.2	14.7	6.6	17.2	15.8	6.9	10.3	10.7	7.4	13.1	12.42	11.91
1974	16.8	19.1	29.1	13.5	40.8	31.4	9.6	25.3	16.2	22.6	18.8	22.00	24.43
1975	1.2	11.2	−5.7	4.6	8.5	3.0	6.7	6.4	−2.3	22.2	9.3	6.93	5.12
1976	7.1	5.1	7.4	3.7	23.8	5.0	7.8	9.0	−0.7	17.3	4.6	6.58	8.09
1977	2.4	7.9	5.6	2.7	16.6	1.9	5.8	9.2	0.3	19.8	6.1	6.35	6.55
1978	−1.9	9.3	4.3	1.2	8.4	−2.5	1.3	7.6	−3.4	9.1	7.8	4.99	2.86
1979	6.3	14.4	13.3	4.8	15.5	7.3	2.7	12.5	3.8	12.2	12.5	10.73	9.39
1980	5.8	13.5	8.8	7.5	20.1	17.8	8.2	13.9	5.1	16.3	14.0	13.33	12.82
1981	8.2	10.1	11.0	7.7	16.6	1.7	9.2	11.6	5.8	10.6	9.0	8.50	8.13
1982	7.7	6.0	11.1	5.8	13.9	1.8	6.6	12.6	2.6	8.6	2.1	4.80	6.85
1983	5.2	3.5	11.0	1.5	10.5	-2.2	1.8	11.2	0.5	5.5	1.3[b]	2.73	3.82

—Not available.

Source: IMF, *International Financial Statistics, 1982 Yearbook* and August 1983, line 63; wholesale price indices including finished goods and primary products.

a. United States excluded.

b. Preliminary data.

Chairman **LAFALCE**. Thank you very much, Professor McKinnon. We will now hear from Scott Pardee, executive vice president, Discount Corporation of New York, formerly with the Federal Reserve Bank of New York, correct, Mr. Pardee?

STATEMENT OF SCOTT E. PARDEE, EXECUTIVE VICE PRESIDENT, DISCOUNT CORPORATION OF NEW YORK AND FORMERLY WITH THE FEDERAL RESERVE BANK OF NEW YORK

Mr. **PARDEE**. Yes. I was 19 years with the Federal Reserve Bank of New York and ended up a senior vice president in charge of Foreign Exchange Operations, conducting the operations on behalf of the Federal Reserve System and the U.S. Treasury.

At the Discount Corporation of New York we have a small, but active foreign operation. I have seen the exchange markets from both sides of the fence, from inside the Fed and in the private markets.

I think that no exchange rate for the dollar is the right rate for everyone. A strong dollar benefits many Americans by keeping inflation down at home and enhancing our purchasing power abroad.

For the same reason it benefits U.S. industries which depend heavily on foreign suppliers of raw materials or components, and it encourages foreign investment in U.S. equities, bonds, real estate, and many other assets.

But the dollar's strength has also created many serious problems which you, Mr. Chairman, and several other panelists have outlined.

There is a case to be made for doing something now to keep the dollar from becoming in some sense too strong such that the damage outweighs the immediate benefits. This would mean taking action to keep the dollar from rising sharply again in the exchange markets and perhaps even to push it down from current levels.

I would like to stress that in the 1970's we had the opposite problem. The weak dollar helped some Americans and hurt others. Ultimately the damage became so great in terms of increasing inflation here and the loss of confidence in the United States abroad that the U.S. authorities took action to halt the dollars slide and even to turn it around.

Now with so many conflicting interests in the market, it is impossible to say what should be the right exchange rate for the dollar, but there are levels which are clearly wrong in a policy sense, and in all cases here I am talking of a policy decision made by the authorities of the United States.

The emergence of wrong rates frequently has less to do with economic fundamentals and economic policy than with market dynamics. For any exchange market participant, trading currencies is a very hazardous business. Markets are effectively open around the clock and events in any part of the world can spark a surge of buying or selling of dollars. Daily turnover these days runs about $200 billion.

Nevertheless, some players deal in large amounts and can influence rates by the trades they do or by the very rumor that they are buying or selling. The Foreign Trade Bank of the Soviet Union is perhaps the most discussed swinger in the interbank market right now, but there are others.

In markets other than foreign exchange, there is a certain virtue in being a contrarian. In foreign exchange markets today it is suicidal. The best strategy is to find the trend and then to ride it. As they say in the currency pits of Chicago, the trend is your friend.

Exchange rates can move 1 or 2 percent in a matter of minutes, as happened this morning, 5 percent or so in a matter of days, 10 percent or so in a matter of weeks and 50 percent or so in a year. Exchange rates do not rise or fall in a vacuum——

Chairman **LaFalce**. The only thing I would like to know is a little bit of advance notice would be quite helpful. [Laughter.]

Mr. **Pardee**. That is why we trade foreign exchange at the Discount Corporation of New York, to find out what is happening in the market before it affects the Government securities market.

Exchange rates do not rise or fall in a vacuum. A rate which is driven to extreme levels merely by market forces will very soon begin to affect the rest of the economy. Instead of having the exchange rate adjust to underlying economic conditions, as the textbook suggests, there is the risk to the economy—that is domestic prices and jobs—will adjust to exchange rates which have been pushed to exaggerated levels.

The textbooks suggests that counterbalancing forces will quickly emerge within the exchange market and normally this happens. At times, however, a stampede psychology takes hold and there is a full-scale run on a currency, just as there is a run on a bank. Everyone wants out at the same time, all sellers and no buyers.

I have seen several such runs in my own experience on the dollar and on other currencies and they are frightening in themselves. They are extreme examples of the kind of disorderly market conditions which are used as the rationale for direct intervention by the authorities in the exchange market. This intervention is done by the central bank buying or selling currencies in the market, operating with balances at hand or from credit lines.

Unfortunately, central bank intervention has become a value-laden term for people of various economic persuasions in this country, something to be for or against in an ideological sense. It is also a controversial concept in the market where the decision to intervene pits the central bank against the very market participants who are profiting from the trend the central bank is trying to stop.

Intervention is not a panacea. I have seen many intervention operations which have been disastrous. If fiscal policy is too expansive, if monetary policy is too expansive and if an administration loses the confidence of traders in the markets, then intervention can be counterproductive except as a means of buying time—what we used to call a holding action, or as a means of damage control, what we call a rear guard action in those contexts.

Not to intervene, however, leaves our Nation's currency at the mercy of market forces. It also leaves active intervention policy totally in the hands of foreign authorities.

Since the early 1960's, I and others in the international financial community have extolled the virtues of central bank cooperation. This is strictly in the United States self interest. Through our willingness to intervene we can get the authorities of other countries to cooperate with us, and cooperate, damn it, this is the attitude that we often have.

By leaving the field of action completely to them in the last 4 years, the United States has lost a good deal of our influence on the foreign exchange operations of foreign governments.

For the first time since the war, the United States now faces effectively a common dollar policy among the major European countries. They act in concert in intervention in the currency markets for the dollar whether or not the United States is willing to join.

Chairman LAFALCE. Is that problem one caused primarily by the attitude of the Fed, primarily by the attitude of the administration, or a combination of the two?

Mr. PARDEE. I think it is more of a problem from the administration than from the Fed.

Chairman LAFALCE. Well, let's explore that after you have finished.

Mr. PARDEE. What to do? I cannot overemphasize the damage that the huge fiscal deficit is doing to us. No nation in history has run a large deficit for very long without ultimately undermining the value of its own currency.

Chairman LAFALCE. In boom times.

Mr. PARDEE. Yes, and I go on discussing the deficit, much of which has been covered here already.

I also think too much is being asked of the Federal Reserve right now to keep the economy going, to contain inflation, to keep the financial system sound in the face of widespread credit problems at home and abroad, to adjust to a world which is increasingly deregulated and, if necessary, to counter disorderly conditions in the exchange market.

The Federal Reserve needs additional policy tools to deal with these problems each in its own way. Specifically, I believe the Fed should have greater freedom to intervene in the exchange market than has been allowed by the Treasury in recent years. Otherwise we risk the dilemma of having the Federal Reserve forced to ease monetary policy because the dollar is strong or tighten monetary policy——

Chairman LAFALCE. Why does the Treasury have to approve or disapprove of Fed intervention?

Mr. PARDEE [continuing]. The ultimate responsibility for foreign exchange policy in the United States rests with the Treasury, or ultimately with the President but through the Treasury. The Federal Reserve cannot conduct foreign exchange——

Chairman LAFALCE. Including the method of intervention?

Mr. PARDEE. Even intervention, yes, sir.

Chairman LAFALCE. Could legislation give the Fed some independence on that issue as they have independence on domestic monetary policy?

Mr. PARDEE. I suppose it could. They have article 14 of the Federal Reserve Act which allows the Federal Reserve to conduct operations in cable transfers, but I think it is better to have a coordinated policy between the Treasury and the Fed.

My suggestion at this point is one which befits the strategic importance of the dollar of the United States and of the free world.

A further sharp rise in the dollar exchange rate is not in our interests at this time. At the same time, a sharp reversal of the dollar could accumulate just as easily as has the rise, which is not in our interest either.

I believe that this is a time to begin building a strategic currency reserve in German marks, Japanese yen, Swiss francs, and other major currencies. The purchases would be on a day-to-day basis, market conditions permitting.

The effect, of course, would be to lean against the wind to moderate the rise in the dollar. On days when the dollar might be easing or flat, the program would be suspended.

Chairman LAFALCE. How large would such a reserve have to be in order to be meaningful?

Mr. PARDEE. I say $30 billion and others say $50 billion or $70 billion. It has to be in tens of billions of dollars. We only have around six or so now.

If the fiscal deficit is not curbed and the Federal Reserve is not forced to monitor that deficit and if inflation revives in the United States for whatever reason, the dollar could again become the whipping boy in the exchanges with profound implications for trade and financial markets, not to speak of our prestige. So I think we have to have this reserve for the next time around when the dollar begins to decline.

Now the second thing I would like to suggest is the Federal Reserve should be allowed to become a regular modest participant in the market. The operation to accumulate a currency reserve would help, but has not assurance of continuity.

One means of participating might be for the Federal Reserve to conduct open market operations through both the domestic open market desk and the foreign desk. Foreign central banks frequently use exchange market operation swaps and the like to add or drain liquidity. The Federal Reserve might consider similar operations.

Another technique might be for the foreign desk to make markets through interbank dealers when trading becomes especially ragged; that is, to be prepared to buy or sell currencies when the market makers are unsure of their footing. Transactions would be reversed as soon as trading conditions are restored. We conducted such operations successfully and made money on them on several occasions in the late 1970's and early 1980's.

These and other kinds of operations I could suggest are highly technical, but they would work toward restoring the depth and resiliency of the currency market.

I have no plan for reforming the international monetary system, but I just think we should try to make the system we have work a little bit better.

[The prepared statement of Scott E. Pardee, entitled "The Right Approach to Wrong Exchange Rates," follows:]

STATEMENT BEFORE HOUSE SUBCOMMITTEE ON ECONOMIC STABILIZATION OF THE COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS

THE RIGHT APPROACH TO WRONG EXCHANGE RATES

SCOTT E. PARDEE

EXECUTIVE VICE PRESIDENT

DISCOUNT CORPORATION OF NEW YORK

MAY 14, 1985

WASHINGTON, D.C.

THE RIGHT APPROACH TO WRONG EXCHANGE RATES

No exchange rate for the dollar is the right rate for everyone. A strong dollar benefits the American consumer by keeping inflation down at home and enhancing our purchasing power abroad. For the same reason it benefits U.S. industries which depend heavily on foreign suppliers of raw materials or components. And it encourages foreign investment in U.S. equities, bonds, real estate, and many other assets. For the Administration, the strong dollar has been considered a badge of success in other areas---a sound economy, low inflation, political stability---which enhances America's prestige and bargaining power in world affairs. For the U.S. Treasury, the strong dollar has facilitated the marketing of U.S. government securities to foreign investors at a time when the huge fiscal deficits are absorbing the lion's share of domestic savings. For the Federal Reserve, the strong dollar has kept a check rein on inflation.

But the dollar's strength has also created many serious problems. It has hurt many U.S. industries competing with foreign producers and has led to a severe loss of jobs in some of those industries. It has clearly dampened the growth of GNP over recent quarters and could conceivably lead to negative growth in the quarters ahead. For the Administration, the strong dollar has generated increased pressure for protection by those domestic industries which have been hurt, and by those Americans whose jobs have been lost or threatened, in direct challenge to the nation's commitment to free markets and liberal trading practices. Protectionist action here would surely invite retaliation abroad, with little net gain for either U.S. or our trading partners---and perhaps even a net loss to all. As it is, the strong dollar has complicated the Administration's direct relations with foreign leaders who are unwilling to accept that the weakness of their currencies against the dollar should be considered a badge of failure for them and their policies. This is why foreign exchange matters are so hotly debated at Economic Summits these days. Nor is the strong dollar an unmitigated blessing for the Treasury. Slower growth at home means lower tax revenues than otherwise, swelling the fiscal deficit which must be financed. And for the Federal Reserve, slow growth complicates monetary policy, forcing the Fed to maintain an easier policy than it might otherwise want in its efforts to wring inflation out of the economy.

There is thus a case to be made for doing something to keep the dollar from becoming in some sense too strong---such that the damage outweighs the immediate benefits. This would mean taking action to keep the dollar from rising sharply again in the exchange markets and perhaps even to push it down from current levels.

I would like to stress that in the 1970's we had the opposite problem. The weak dollar helped some Americans and hurt others. Ultimately the damage became so great, in terms of increasing inflation here and the loss of confidence in the U.S. abroad, that the U.S. authorities took action to halt the dollar's slide and even to turn it around.

With so many conflicting interests in the market, it is impossible to say what should be the right exchange rates for the dollar, but there are levels which are clearly wrong in a policy sense. I will not try to define "wrong rate" specifically for the same reason the drafters of the Articles of Agreement of the International Monetary Fund decided not to define "fundamental disequilibrium" as the rationale for adjusting an exchange rate parity under the Bretton Woods fixed rate system. It is a matter of judgment for the authorities in power at the time. On those occasions, action should be taken to avoid an even further adverse swing in rates or even to correct the excessive swing which has already occurred. Ideally, the authorities should take action to avoid the conditions from which wrong rates emerge in the first place.

The emergence of wrong rates frequently has less to do with economic fundamentals and economic policy than with market dynamics. For any exchange market participant, trading currencies is a very hazardous business. Markets are effectively open around the clock. Events in any part of the world can spark a surge of buying or selling of dollars. Daily turnover these days averages some $200 billion. Nevertheless, some players deal in large amounts and can influence rates by the trades they do or by the very rumor that they are buying or selling---the Foreign Trade Bank of the Soviet Union is perhaps the most discussed swinger in the interbank market right now, and there are others. In markets other than foreign exchange, there is a certain virtue in being a contrarian. In foreign exchange markets today it is suicidal. The best strategy is to find the trend and then ride it---or as they say in the currency pits in Chicago, the trend is your friend. Exchange rates can move 1 or 2% or so in a matter of minutes, 5% or so in a matter of days, 10% or so in a matter of weeks, and 50% or so in a year. Generating a trend or catching one right is exceedingly difficult. Sudden shifts in market psychology can lead to sharp swings in rates and to punishing losses to those who are caught in the wrong position. Volatility forces market makers to step back, widen their bid-asked spreads, and to cover long or short positions quickly. In this environment, the market loses depth, breadth and resiliency, and exchange rates can rise or fall cumulatively, driven by the dynamics of market forces.

Exchange rates do not rise and fall in a vacuum. A rate which is driven to extreme levels merely by market forces will very soon begin to affect the rest of the economy. Instead of having the exchange rate adjust to underlying economic conditions, as the textbooks suggest, there is the risk that the economy---that is domestic prices and jobs--- will adjust to exchange rates which have been pushed to exaggerated levels.

The textbooks suggest that counterbalancing forces will quickly emerge within the exchange market, and normally this happens. At times, however, a stampede psychology takes hold and there is a full-scale run on a currency, just as there is a run on a bank. Everyone wants out at the same time---all sellers and no buyers.

I have seen several such runs in my own experience, on the dollar and on other currencies, and they are frightening in themselves. They are extreme examples of the kind of "disorderly market conditions" which are used as the rationale for direct intervention by the authorities in the exchange market. This intervention is done by the central bank buying or selling currencies in the market, operating with balances at hand or from credit lines.

Unfortunately, central bank intervention has become a value-laden term for people of various economic persuasions in this country, something to be for or against in an ideological sense. It is also a controversial concept in the market, where the decision to intervene pits the central bank against the very market participants who are profiting from the trend the central bank is trying to stop. Is intervention necessary? Does it work? Is it profitable? Some people say yes to all these questions, some say no. I am a pragmatist. Sometimes intervention has been necessary, sometimes it works, and sometimes it is profitable. At other times it can be disastrous.

Intervention is not a panacea. If fiscal policy is too expansive, if monetary policy is too expansive, if an Administration loses the confidence of traders in the markets, then intervention can be counterproductive except as a means of buying time---a holding action--or as a means of damage control---a rear guard action. For all the talk about the strong dollar, right now I believe that the next big move for the dollar will be lower. The fiscal deficit and the trade deficits are just too large, and foreign investors are becoming increasingly chary of placing new funds here.

Not to intervene however, leaves our nation's currency at the mercy of market forces. It also leaves active intervention policy totally in the hands of foreign authorities. Since the early 1960's, I and others in the international financial community have extolled the virtues of central bank cooperation. This is strictly in the U.S. self-interest. Through our willingness to intervene we can get the authorities of other countries to cooperate with us. By leaving the field of action completely to them in the last four years, the U.S. has lost a good deal of our influence on the foreign exchange operations of foreign governments. For the first time since the war, the U.S. now faces effectively a common dollar policy among the major European countries. They act in concert in intervention in the currency markets for the dollar whether or not the U.S. is willing to join.

By not intervening, the U.S. authorities lose touch with the market. A central bank that is not a regular participant in the market is not going to get complete and accurate information on what is happening. Foreign exchange traders are after all businessmen and women, and many of them are unwilling even to answer the phone unless they believe the call could result in a trade.

What to do? I cannot overemphasize the damage that the huge fiscal deficit is doing to us. To the extent that the deficit has raised interest rates here, it has contributed to the strong dollar that has hurt so many sectors of the U.S. economy. Until now, foreign investors have remained confident in the outlook for the U.S. However, no nation in history has run a large deficit for very long without ultimately undermining the value of its own currency. Unless the fiscal deficit is curbed, it is just a matter of time before the confidence ebbs and the dollar falls.

I also think too much is being asked of the Federal Reserve right now---to keep the economy going, contain inflation, keep the financial system sound in the face of widespread credit problems at home and abroad, adjust to a world which is increasingly deregulated, and, if necessary, to counter disorderly conditions in the exchange market. The Federal Reserve needs additional policy tools to deal with these problems, each in its own way.

Specifically, I believe the Fed should have greater freedom to intervene in the exchange market than has been allowed by the Treasury in recent years. Otherwise we risk the dilemma of having the Federal Reserve forced to ease monetary policy because the dollar is strong or tighten monetary policy because the dollar is weak when such actions are not justified for domestic reasons.

This dilemma is real. In recent months the U.K. authorities chose to deal with an excessive decline of the pound sterling by intervening only modestly while tightening monetary policy drastically, jacking up interest rates to astronomical levels--a risky approach in view of the high unemployment level in that country. By contrast, the West German authorities responded to a weakening of the mark against the dollar by intervening forcefully, in coordination with other central banks while tightening monetary policy only modestly--seeking to avoid aggravating domestic unemployment. Right now, both strategies seem to have worked, but the one based on forceful intervention was less risky as far as domestic jobs were concerned. The interventions ---which totaled more than $10 billion---were also highly profitable, by more than $1 billion in view of the dollar's subsequent 10% decline. That's good trading by any measure.

My suggestion at this point is one which befits the strategic importance of the dollar to the U.S. and to the Free World. A further sharp rise in dollar exchange rates is not in our interest at this time. At the same time, a sharp reversal of the dollar, which could cumulate just as easily as has the rise, is not in our interest either. The United States government has over the years stockpiled strategic materials, against dire but unforeseen contingencies. The U.S., unlike other countries, has never amassed a foreign currency reserve, depending on our gold stock during the Bretton Woods days, and on the Federal Reserve swap network and other credit facilities when we needed currencies during the 1960's and 1970's. The credit facilities are still on the books but the spirit of cooperation which made them work is gone. The next time around, the defense of the dollar will have to be conducted largely by the U.S. before other countries could be persuaded to join in on any form of cooperative venture.

I believe, therefore, that this is the time to begin building just such a strategic currency reserve, in German Marks, Japanese Yen, Swiss Francs and other major currencies. The purchases would be on a day-to-day basis, market conditions permitting. The effect, of course, would be to lean against the wind, to moderate the rise of the dollar. On days when the dollar might be easing, or flat, the program would be suspended. Then when the dollar declines--which sooner or later it will--the U.S. authorities will have some reserves to feed back into the market, to lean against the wind and avoid an inflationary overshooting in the opposite direction. If the fiscal deficit is not curbed, if the Federal Reserve is forced to monetize it, if inflation revives in the U.S. for whatever reason, the dollar could again become the whipping boy of the exchanges, with profound implications for trade and financial markets, not to speak of our prestige.

Second, the Federal Reserve should be allowed to become a regular modest participant in the market. The operation in accumulating a currency reserve would help but has no assurance of continuity. One means of participating might be for the Federal Reserve to conduct open market operations through both the domestic open market desk and the foreign desk. Foreign central banks frequently use exchange market operations, swaps and the like, to add or drain liquidity. The Federal Reserve might consider similar operations. Another technique would be for the foreign desk to make markets to interbank dealers when trading becomes especially ragged, that is, be prepared to buy or sell currencies when market makers are unsure of their footing. Transactions would be reversed as soon as trading conditions are restored. We conducted such operations on several occasions in the late 70's and early 80's. They generally had the effect of calming the market and helped gain the respect of the dealer community. We also made money at it. By this means we improved our information flow and could be much more effective when conducting larger scale interventions. These and other kinds of operations I could suggest are highly technical, but they would work toward restoring the breadth, depth, and resiliency of the exchange market. I have no plan for reforming the international monetary system. I just think we should try to make the system we have work better.

Chairman LaFalce. Thank you very much, Mr. Pardee.

Each of you gentlemen has presented excellent testimony. It is certainly going to benefit me greatly in my deliberations.

What I am very interested in now is rather than asking you questions, I would prefer to be a moderator of a discussion amongst the five of you and maybe the six of us and any other Congressmen that join us.

My first question in order to provoke discussion would be, what did you most hear from the other four panelists that you didn't mention in your own statement that you most agree with or even more so most disagree with?

Mr. Reuss. I stressed getting the fiscal deficit under control as the beginnings of wisdom, but I thoroughly agree with what has been widely said here that you never can tell exactly what the first effects of doing the right thing may be. No one should advance the proposition that simply doing what we have to do with the deficit for a variety of reasons is in and of itself going to fix up the international value of the dollar.

So I am most sympathetic to Mr. Pardee's suggestion that we ought to be amassing a little fund of foreign currencies, the yen, deutsche mark, and Swiss francs.

Chairman LaFalce. How do we amass this?

Mr. Reuss. It would have the effect, I think, which perhaps Mr. Pardee didn't mention, but wouldn't amassing that, or raising our $6 billion of foreign currency reserves to $20 billion or $30 billion, that would probably have a favorable immediate effect, wouldn't it? It would cause the dollar to sell off a little bit and that is a sensible thing to do. And then it would put us in better shape for the next round. I hope we won't get into what the central banks of some of our——

Chairman LaFalce. The next round of——

Mr. Reuss. The next round when the dollar may be sinking too far or too fast. The dollar will continue to fluctuate, and the point must be to moderate though.

Chairman LaFalce. You cautioned counsel against intervention if the dollar were depreciated.

Mr. Reuss. Yes; and I have changed my mind on that shibboleth of mine in the light of what I regard as the present precarious nature of the dollar. I think it is so out of whack that we need an extra line of defense. I think cautious, and one hopes coordinated, intervention would ease the bumps and enable us to prevent its falling out of sight without disturbing people too much.

Chairman LaFalce. What is the mechanism, Mr. Pardee, for increasing the reserves?

Mr. Pardee. It is very simple. There would be a decision of the U.S. Treasury or again I think in consultation with the President, who has actually taken a very strong position on the whole question of intervention.

Chairman LaFalce. Against intervention.

Mr. Pardee. Yes, at summit meetings and so forth. But the view that I have is you don't have to change the rationale on intervening to counter disorderly conditions. The markets are very disorderly. With 2 and 3 percentage point movements each day, you can always say that that is disorderly.

And, also, there is another rationale: to buy currencies for future contingencies. That is what I really had in mind. Either you can announce it, if you wish, which would have a market effect. If you are talking about buying very large amounts, it would have a psychological effect on traders. Or you can just quietly start buying the currencies on days when the dollar is strong, $100 million here and $100 million there, not necessarily trying to push the dollar down, but resisting the rises on days in which all of a sudden the dollar comes into heavy demand.

This would provide a little more substance to the market because the U.S. market is particularly volatile in the afternoons after the European markets close. It would be a matter of judgment between the U.S. Treasury and its staff and the Federal Reserve and its staff as to how this program would be moving ahead.

Chairman LaFalce. I don't want to focus in just on that one issue. I simply want to go around to see what you most agree or most disagree with.

Do you want to get your disagreement in?

Mr. Reuss. If I may just mention a couple of other things.

I would like to ask Mr. McKinnon this. It is fine to use exchange rates as the goal of monetary policy when that more or less coincides with what you are going to do domestically. Like right now, I think if we did get the budget under control it would be great stuff to ease the monetary policy a little bit and that would serve the needs of foreign exchange, too.

But on the other side I wish you would address yourself to the economic consequences of Winston Churchill in 1923 and other occasions, when people have used domestic monetary policy to influence the value of the pound, the franc or whatever with sometimes counterproductive effects at home.

Chairman LaFalce. By counterproductive, you mean inflation?

Mr. Reuss. Yes. The other little point I would like to make to Mr. Johnson, is didn't we goof off a bit when we brought all that pressure on Japan a while ago saying open up your controls on the ability of the Japanese capitalists to send their capital abroad? Everybody said that is great, but of course the more that is done the more it weakens the end and increases the disparity. Shouldn't we forget about that one?

Mr. Johnson. Well, it is true that Japan is a major capital exporter. I think our point was in our statements about the Japanese—that they clearly do have some nontariff barriers that we think are very strong. They also have a relatively closed capital market though, in other words, of not allowing direct foreign investment into Japan. Of course the feeling was there that more direct foreign investment in Japan would increase the demand for yen as the denominated asset.

Mr. Reuss. That part is right, but we also leaned on them saying ease up on your controls on the exit of yen from Japan quite heavily, and I think mistakenly. My question is since we all err bountifully, shouldn't we forget about that pitch?

Mr. Johnson. I can't remember that particular statement, but I think we definitely agree in free capital flows. So at least as far as the Treasury is concerned, I don't think that we had any position to try and restrict their capital outflows.

Mr. **Reuss.** No, that is the trouble. The Japanese had in place a pretty good, though maybe statused in a system of controls on the outflow of their capital, and we huffed and puffed and got them to relax it with the result that more capital now leaves Japan. But that adds to the problem.

Mr. **Johnson.** But I think that the other point is we certainly don't want to force them to put on more controls on the export of capital, but we do want to encourage them to open their markets more toward the importation of capital, and I think that is where we can make gains.

Mr. **Reuss.** Yes, but we make losses I claim by condemning their dreadful statism. Why don't we calm down on that. If they want to be statists on keeping the yen at home, that is really probably a good thing and we should turn the other way.

Mr. **Johnson.** Well, you know, from an international liquidity point of view I think that it is not necessarily good, but I mean it certainly does produce the demand for dollars to some extent.

Chairman **LaFalce.** How does your statement, Henry, square with the concept that many espouse that we need in order to bring the dollar down to internationalize the yen?

Mr. **Reuss.** Well, that statement is I think a little loose. We need somehow vis-a-vis the yen to get the yen up a little bit and the dollar down a little bit.

My point was simply this, that while of course we want to have the Japanese open up their markets to foreign capital, that, among other things, brings the yen up.

Chairman **LaFalce.** Well, I would appreciate it if you could take a look at the testimony given before our subcommittee on this issue by the National Association of Manufacturers and their recommendations and give me your verbal comments by phone.

Mr. **Reuss.** I will be glad to.

Chairman **LaFalce.** Mr. Johnson, tell us your strongest areas of agreement and strongest areas of disagreement.

Mr. **Johnson.** Well, no real strong points, but there are a couple of thoughts I had in listening to the other testimony.

First, I think with Dr. McKinnon's points. He makes some interesting observations and recommendations. However, there is one problem I think when you do try to go to a fixed exchange rate regime and that is especially if you have a fixed exchange rate regime within a group of countries that don't have the same internal types of domestic structure and things like that.

A lot of times the spillover effects since you are basically saying well, we are not going to allow the exchange rate to adjust any domestic imbalances, and all the sudden then generally any adjustment has to take place in the domestic economy.

Chairman **LaFalce.** Of course, he wasn't really talking about a fixed rate, was he?

Mr. **Johnson.** Well, he was talking about within some relatively narrow range which would require countries to support their currencies within some band.

Chairman **LaFalce.** But within that band wouldn't they have the flexibility to adapt to domestic concerns, too?

Mr. **Johnson.** Once again, I guess it depends on how you define the band. I know under Bretton Woods, which has been mentioned favorably, there was a way to, if in fact you found your domestic economy sort of unbalanced with the rest of the participants, you could adjust the band in which you were to peg to the dollar and this could gradually move your economy toward more balance at the same time that you are trying to keep exchange rates relatively fixed.

However, if you don't take special care with regard to something like that, you could really destabilize the domestic economies at a fixed exchange rate. I mean I'm just saying you would have to be extremely careful in selecting the relative exchange rates, and often it is not very easy when you have countries of different types of structures.

Therefore, a lot of people advocate that it might be better just to peg directly to some sort of stable commodity or something rather than trying to——

Chairman LaFalce. Gold?

Mr. Johnson. Well, any kind of stable commodity, I should say, but those have been some recommendations I think to try and avoid those kinds of problems. But once again, even there you get your economy out of line and you have to have a certain amount of discipline to stick with it.

Another point was on Fed intervention. It is true that there has to be coordinated action with the Fed and the Treasury Department on intervention of the currency markets, and the Treasury is responsible for initiating any types of intervention activity.

However, the Treasury does not control the effect of the monetary policy on the money supply of any decision to intervene. In other words, quite often the Federal Reserve may choose to at the same time that it is say selling dollars to actually offset that in its foreign accounts, in other words, sterilizing the effect of an intervention on the money supply.

I think most people would say that if you pursued sterilized intervention you really don't get any fundamental change in the longrun exchange rate because you haven't changed the growth rate of money relative to some other economy and, therefore, you can't really effect relative exchange rates.

Now it is true that sterilized intervention, in other words, selling dollars but offsetting that by buying dollars in the foreign account might break some sort of disorderly condition or psychological developments in the marketplace on a temporary basis, but they won't change the fundamental exchange rate.

So really to have any kind of intervention that ultimately and substantively affects the exchange rate you would have to have a coordinated intervention of the type where the Treasury directed the Fed to sell dollars and this was not offset in its foreign account at the Fed.

The Treasury doesn't have the authority to make that determination. The Federal Reserve does. So there is some authority on both sides there. I think it is an important point. Unless you really alter fundamentally the growth rate of the money supply, you really don't really do anything to the relative exchange rate.

Chairman LaFalce. Mr. Smith, your strongest areas of agreement and strongest areas of disagreement?

Mr. SMITH. Well, I think one of the things that my other panel colleagues have mentioned that I would strongly agree with is that there is no guaranteed linkage that a reduction in the Federal deficit is going to immediately bring about either a precipitous or a soft landing movement in the dollar.

But it certainly, I believe, would be true that a reduction in the Federal deficit would reduce real interest rates as they exist in the United States and the influence that those real interest rates have on the other major industrialized countries of the world.

At least you get one of the confusing elements in this complex situation that we are operating in in trying to deal with the strong dollar out of the way if you get the deficit down and if you get U.S. interest rates down. Then you are going to find an environment in which American business is going to become more competitive with outside the U.S. business. As a result you will begin to see capital formation take place because of an opportunity for greater return, and I believe that this is a very important aspect for keeping our manufacturing infrastructure together.

I mean the trend of decline in the portion of the real GNP that manufacturing in the United States represents since the late 1950's and early 1960's would indicate that if the trend continued to the year 2000, that we are really going to be dominated as a service economy and what will we have to maintain our position in the world as an economic factor.

Mr. JOHNSON. I remember one point I wanted to make with respect to the Kodak testimony, if I could. One point that I was reminded of when the testimony was given was that it was pointed out the effect of the strong dollar on the earnings of Kodak Co., and I am sure that is true.

But one problem we have to remember is that if you pursue a policy that just seeks to reduce the value of the dollar, other things don't remain constant. For instance, if you pursue a policy of trying to move the dollar down by accelerating the growth of the money supply, you could increase the money supply to the point where you are actually adversely affecting commodity prices.

I remember Kodak is also very sensitive to silver prices, and I would say there is almost an inverse relationship between silver commodity prices and the dollar exchange rate. So that if you were to attempt to get the dollar down by printing too much money, you could seriously adversely affect silver commodity prices or any other commodity price for that matter.

Chairman LAFALCE. Are you suggesting that the price of silver has served as an offset to the earnings of Kodak in sum insofar as the——

Mr. JOHNSON. Quite possibly. I don't know what their relative balance sheet would look like.

Chairman LAFALCE. Would Kodak care to comment on that?

Mr. SMITH. The one thing that would be nice about that is it would affect all the people we compete with equally. End of comment. [Laughter.]

Chairman LAFALCE. I don't think you need say any more. [Laughter.]

Mr. JOHNSON. It is not necessary. [Laughter.]

Chairman LaFalce. Mr. Smith, other than that area of disagreement with Mr. Johnson, are there any other areas of disagreement that you feel strongly about that you would like to mention?

Mr. Smith. No, no other areas of disagreement that I feel strongly about.

Chairman LaFalce. All right, fine.

Mr. McKinnon.

Mr. McKinnon. Congressman Reuss and Secretary Johnson, to sum up their views on using monetary policy to manipulate the exchange rate, I think there might be a certain amount of sympathy with getting the dollar down, the one-time devaluation, but maybe Secretary Johnson has less sympathy with that.

But they were distinctly uneasy about the idea of going back to narrow exchange rate bands on a more or less ongoing basis and subordinating U.S. monetary policy to maintaining that virtual fixed exchange rate system, and whether or not this would benefit the United States apart from the foreign trade question is largely an empirical matter and it is difficult to settle theoretically.

And Congressman Reuss gave the textbook case, which is correct, that there may be a conflict between internal needs and external needs. If we committed ourself to a fixed exchange rate might we not then find ourselves in a dilemma?

But I think you can show that if you are highly integrated with the outside world, both in terms of capital flows and trade flows, that there is unlikely to be any such dilemma, and that sort of international and domestic needs are the same.

What we are lacking in the conduct of U.S. monetary policy at the present time is a reliable leading indicator of whether or not money is too tight or easy. It is very ambiguous and very hard to make that judgment.

Now the traditional indicator back in the 1950's and 1960's was the nominal interest rate. When we had expectations of price level stability if nominal interest rates went up, then the Fed expanded, and if they went down, the Fed contracted.

But in the 1980's with inflationary expectations being so unstable, you can't tell what an increase in the nominal rate of interest means. It might mean that just inflationary expectations have risen, and that money is too loose rather than too tight.

So we need a new leading indicator to tell the Fed whether they are being too tight or too easy.

And here I think you can show that the exchange rate, the dollar exchange rate against other hard moneys, the deutsche mark and yen, has been an excellent leading indicator of inflation or deflation to come in the American economy. So if the Fed had paid attention in the past to what the dollar exchange rate was saying, we would have smoothed the cycle of inflation or deflation that we have experienced.

And here I must disagree respectfully with Congressman Reuss who is quite proud of the dollar devaluation of 1971. This was at a time that the dollar was under severe pressure. If President Nixon had not been interested in getting elected in 1972, the economically correct strategy would have been to tighten U.S. monetary policy and not devalue and preserve the fixed exchange rate system, and thereby avoid the great inflation of the 1970's. By the standards of the present day we were not overvalued. In retrospect, however, letting the fixed rate system go was a serious mistake and was what really provoked the great inflation to follow.

I am very sympathetic with Scott Pardee's comments on the Fed intervening somewhat more and setting up a fund perhaps to stabilize the market. But I might just make this point, that the size of the fund that he needs, $30 or $40 billion worth of marks or yen, depends entirely on how much we are willing to harness monetary policy to the intervention.

When the Federal Reserve Bank of New York intervenes and sells dollars and buys deutsche marks, suppose it lets the U.S. monetary base increase by the full amount of those dollars that are pumped into circulation, and then the amount of intervention that would be required would be quite small.

If, however, we don't allow the U.S. money supply to change when we intervene, then the stock of reserves we need to effect a successful intervention could be huge and maybe much greater than what Mr. Pardee suggested.

So the name of the game is to coordinate the intervention with our monetary stance, and then relatively modest intervention can stabilize the exchange market.

Chairman LaFalce. Mr. Pardee.

Mr. Pardee. This has been very interesting colloquy. I think in sorting out my areas of agreement and disagreement with Secretary Johnson, I agree heartily with the view that the coordination of policies is necessary, that is, if you intervene in a way that undermines the thrust of domestic fiscal and monetary policy and just expand the monetary base, however you want to define it, then you are undercutting yourself. So intervention should be coordinated with other policies.

This is why I say intervention is not a panacea and can be disastrous. In many ways in the late 1970's when we were defending the dollar, quite frequently I felt that the answer was tighter monetary policy and not more intervention.

So I think as far as the policy views are concerned, there is no problem. It is a matter of degree and how to interpret conditions in the market. I don't want to put a number on the size of the current reserve needed because if the central bank has a credible approach to the exchange market, it doesn't need many reserves.

We conducted a number of operations in the late 1970's which cost us absolutely nothing, because as soon as the Fed appeared in the market, the people said OK, now the problem is going to be resolved and we don't have to worry so much about it. It is a question of reassuring the market. The exchange market is a very highly psychological market. It needs confidence in the Government, in the central bank, and, indeed, in the coordination among the central banks.

Right now the feeling is that if the Bundesbank were to intervene, it is all by itself. Traders believe they can take the dollar/mark exchange rate wherever they want to once the German market is closed and New York open or the Far East is open. It is a 24-hour market. So the central banks have to coordinate around the clock.

This all can be done. It is just a matter of appreciating the degree to which the market is unstable and the degree to which it is pushing the exchange rates to unrealistic levels and the degree to which coordination would help at this point.

I am a little nervous about Professor McKinnon's suggestions as an economist myself who has worked in policy situations and in markets. Quite frequently a government announces a policy as if it has a tool that it can use to move exchange rates from one level to another, only to find that the tool has no cutting edge to it whatsoever. Indeed, the market may go the other way because traders are confused by what the Government is trying to do.

A one-shot evaluation of the dollar is, in effect, what the Carter administration tried back in the early years, through comments by Secretary Blumenthal. The comments undermined confidence in the dollar at that time. You can't unleash those kinds of forces in a one-shot move.

Mr. SMITH. Mr. Chairman, I would like to heartily second Mr. Pardee's comments regarding the effect that positions or comments taken by officials in the U.S. administration or in the Federal Reserve system can have on the exchange markets because they are in today's environment so psychologically driven.

Mr. Volcker and Mr. Reagan constantly talking about how great the strong dollar is for everyone, I believe, has had a significant effect psychologically on the private traders in the market who make up between 85 and 90 percent of the trading that is going on. Today's foreign exchange trading is not driven by trade activities as it was 20 years ago. The posturing about how great the strong dollar is, if we postured——

Chairman LAFALCE. That is one thing at some point in time, not today, that I would like to get into more. The trading is not driven by trade activities and hasn't had a profound change in the foreign markets, and in how we must deal with the foreign markets. It wasn't anticipated when we went to our current system that capital flows would have such a predominant force. It was thought that trade would be the predominant moving force. Is that correct?

Mr. SMITH. True, and today I believe trade drives less than 5 percent of the foreign exchange volume in transaction amounts.

Chairman LAFALCE. I would like any of you who would like to expand on the problems that that has caused, to do so in writing to me.

Mr. SMITH. I would have to bow to my panel colleagues who are better qualified to comment on that than I. All I can do is look at the data and be aware of that.

Chairman LAFALCE. Please continue your comments.

Mr. SMITH. I think posturing by both Fed and administration people that perhaps there would be some value to a weaker dollar would have an effect on the value of the dollar.

Chairman LAFALCE. Thank you.

With that, Mr. Smith, we are going to let you have the last word, because we have approximately 7 minutes in order to cast a vote on a very, very important issue—approving the journal of the preceding day. [Laughter.]

But, gentlemen, speaking just for myself, I think that your comments have been extremely informative, illuminating and opened my mind to the complexity of the problem. If I thought it was complex before, boy, do I really think it is complex now.

I do think it is important that we start having a dialog on this. We are having a dialog about fiscal policy in the United States, but we are not having very much of a dialog on domestic monetary policy. We have also got some schizophrenia going on within the administration on that. Some say we support the Fed and others say that policy is the cause of all of our problems. Well, schizophrenia or not, at least we have a little bit of dialog, but we have got almost no dialog within the Congress on our international monetary problems.

If there is dialog going on within the administration regarding their international monetary arrangements, it is being done silencio and that ought not to be. It ought to be in the forefront of our economic decisionmaking and discussion. Maybe we could do a little something to bring it more to the forefront, and even if we do that we will have contributed to the mutual cause.

Thank you.

The subcommittee is adjourned.

[Whereupon, at 12:15 p.m., the subcommittee adjourned subject to the call of the Chair.]

THE GROWING CLAMOR FOR PROTECTIONISM

WEDNESDAY, JUNE 26, 1985

House of Representatives,
Subcommittee on Economic Stabilization,
Committee on Banking, Finance and Urban Affairs,
Washington, DC.

The subcommittee met, pursuant to call, at 10 a.m., in room 2128, Rayburn House Office Building, Hon. John J. LaFalce (chairman of the subcommittee) presiding.

Present: Chairman LaFalce; Representatives Lundine, Kaptur, Torres, Kanjorski, Dreier, and Grotberg.

Chairman LaFalce. The Subcommittee on Economic Stabilization will come to order.

One of the most critical issues facing this country is how we will choose to respond to the increasing pressures for protectionist trade policies. At the same time that our trade dependence has increased, our trade performance has become more and more abysmal. The trade deficit has now risen to an astounding $123.3 billion, a level that would have seemed impossible 4 years ago. It will continue to surge upward, soaring as high as $150 billion this year.

As America's trade position continues to deteriorate, the political pressure to reduce foreign imports has risen dramatically. That pressure is reflected in an enormous increase in the International Trade Commission's caseload—up 88 percent between 1981 and 1984—and more than 200 trade bills currently before Congress. Many of these bills call for U.S. action to reduce competition from abroad through the imposition of import surcharges or barriers such as quotas or additional tariffs designed to insulate specific sectors.

There can be no question that the U.S. trade deficit and the overvalued U.S. dollar are having a devastating impact on American industry. U.S. imports in the capital goods sector grew 46 percent in 1984. Recent trade statistics show the United States is also losing its supremacy in high tech goods including computers and telecommunications equipment. Our industrial base continues to erode, and this administration continues to watch it happen.

To date, the administration's primary response to this erosion of our industrial structure has consisted only of a surprising readiness to grant protection to industries politically powerful enough to secure it, coupled with an equally surprising resistance to making such protection an efficient spur to competitiveness. But simply closing our doors to free trade through protectionist tactics is not the answer. Our past experience with such policies clearly demonstrates their futility. Just as we close our doors to specific products from certain countries, other more competitive products from still other competitors take their place.

Not only are such policies futile, they are dangerous. Protection breeds only more protection. Restrictive trade actions taken since 1980 by the major trading nations reflect a new degree of restrictiveness simultaneously in a number of areas, including textiles, steel, footwear, and automobiles. Moreover, a number of other sectors, such as telecommunications equipment and motorcycles, have for the first time been the subject of trade restrictive actions. Protectionism is proliferating and the result could be a trade war of massive and dangerous proportions.

Our increasing reliance on protectionist trade remedies as a solution to industrial competitiveness problems is no substitute for a strategic competitiveness strategy. Insulating our industries from competition is a totally ineffective means of increasing their competitiveness, and also makes it almost impossible to compete in overseas markets. The inevitable result of this approach is to inhibit the very adjustment essential to long-term economic growth.

The increasing preoccupation of our industries with eliciting protection from the Government partly reflects an enormous gap at the policy level. The fact is that the Federal Government cannot act strategically to promote industry adjustment and improve competitiveness. We have no appropriate strategic mechanism to use. Protectionist policies are relied on in large part precisely because we have no apparatus for developing, and no coalition for supporting policies that actively promote American international competitiveness. One of the principal reasons for shaping an industrial competitiveness strategy, in my judgment, is that it is the only positive and effective alternative to eventual self-defeating protectionism.

In some cases, time-limited and conditional protection could be an effective part of such a strategy. But, policies of protection should generally be strategically applied and self-liquidating. Our Government should seek to link protection for an industry to a plan for remaking the industry into a worldclass competitor.

The hearing will explore the extent of, and the reasons behind, the increasing emphasis on protectionist trade policies; the effect of this trend on the competitive position of U.S. industries relying on or seeking import relief and on the policies of U.S. foreign competitors; and the need to place greater emphasis on industry adjustment in the trade relief process by attaching effective conditions to import relief actions.

At this point in the hearing record I would like to have inserted the opening statement of our ranking minority member, Hon. Norman D. Shumway.

[Mr. Shumway's opening statement follows:]

Statement of the Honorable Norman D. Shumway
June 26, 1985

Economic Stabilization Subcommittee Hearing on
The Growing Clamor for Protectionism

Thank you, Mr. Chairman. Let me begin my remarks by welcoming our distinguished panel of witnesses, whose background and "hands on" experience in the area of trade relations will aid this Subcommittee in dealing with the controversial subject of protectionism.

To borrow from the words of Eugene O'Neil, "We can kid the world but we can't fool ourselves." And whether we call it voluntary restraint agreements, import surcharges, domestic content requirements or the like, we cannot delude ourselves into thinking that we are not engaging in the very practice of protectionism -- the practice of our trading partners which we decry and condemn.

With the U.S. trade deficit burgeoning to record levels, it is easy to hop on the "protectionism bound" bandwagon and engage in trade wars with those countries which limit American access to their markets. Indeed, Japan, who enjoyed an embarrassing $37 billion surplus in trade with the U.S. and, at the same time, restricted U.S. imports on manufactured products, has become the primary target for retaliation.

I can appreciate the sentiment. Japan and every other U.S. trading partner imposing import barriers on U.S. goods, are seen as exploiters of the international trading system, rogues threatening the very foundations of open trade. And this nation, who supposedly honors the rules of "free and fair" trade, is the loser. Millions of Americans are thrown out of work, and portions of the nation's industrial sector verge on ruin.

However, we cannot brand Japan as the wicked witch of the east. We cannot attribute our inability to compete to trade barriers. And we cannot delude ourselves into thinking that protectionist measures will make our economy more productive and eliminate our trade deficit.

I believe that in the panic produced by the escalating trade imbalance, we are overlooking some important facts. Most of the trade deficit since 1980 has been caused by the rising dollar, which in turn has been the result of the huge budget deficit. The current projected budget deficit raises real interest rates in the U.S. and attracts funds from the rest of the world. This has raised the dollar's real value in comparison to other currencies by more than 70% since 1980. And with American prices up 70% in comparison to overseas competition, it is not surprising that our trade deficit has exploded. If the deficit is reduced, the result would be a significant decline in the real interest rates, in the dollar and in our trade deficit.

Second, America has recovered much faster from the last recession than have our trading partners. Last year, the American economy grew by 6.8%, compared to 4% in Canada, 2.6% in West Germany and 1.6% in Great Britain. Japan, with 6.2% growth, also lagged behind the U.S. Consequently, American businesses and consumers have more money to spend than their foreign counterparts. So the U.S. imports more than they do. Our trade balance normally deteriorates in an expansion, but the comparative vitality of the U.S. recovery has exaggerated the pattern.

Third, while we think of the U.S. as a paragon of free trade, let us not overestimate our virtue. It is interesting to note that this country has approximately 45% of its manufactured imports subject to some form or another of nontariff barrier. Consumers are already paying higher prices because of these tariffs. If we impose additional surcharges or limit foreign imports, we are hurting only ourselves in the form of higher prices and the expense of maintaining a limited number of jobs. This form of protectionism has no broad benefit to society.

While the budget and trade balance would look better through protectionism, it doesn't solve our trade problems. More importantly, this type of action invites retaliation on the part of our trading partners which will work against the national interests of the United States in the long run. The United States must be partners, not adversaries, with other countries.

Let us not allow emotionalism interfere with economic logic. If our existing trade laws are not working, let us strengthen them. If the budget deficit is contributing to the trade imbalance, let us work to lower it. But let us not pursue policies, practices and attitudes that will cripple our ability to compete in the international arena. If we do, it will only be a pyrrhic victory, at best.

Chairman **LaFalce**. We have three outstanding witnesses to help us explore these important issues. I shall now introduce two: First, Hon. Paula Stern, Chairperson of the International Trade Commission; and second, William Cline of the Institute for International Economics.

I would now like to call upon not only a greatly respected colleague, in my judgment, the person in not only the House but the U.S. Senate most knowledgeable about the entire issue of trade, but also most influential on the issue of trade—one with whom I share not only a great bond of friendship but a great philosophical affinity, also, when it comes to these trade issues. I would ask Hon. Sam Gibbons to introduce our third distinguished witness.

Mr. **Gibbons**. Thank you, Chairman LaFalce.

I want to express my personal appreciation for the opportunity to be here. But I want to officially say I welcome these hearings. We need a broad discussion in Congress, not only in my little subcommittee but all over the Congress.

The job assistance program you referred to expires this year, and it is in danger of never being revived. We labored in that field for quite some time. Perhaps together we can work out something sensible for the United States. Certainly, we do need adjustment.

But I don't want to take any of the time of the witnesses because you have a very distinguished panel here. It is my privilege and pleasure to introduce my friend, neighbor, and constituent, Frank Morsani. Mr. Morsani is the chairman of the U.S. Chamber of Commerce, the largest organization of private individuals and private businesses in the world.

Mr. Morsani has earned this rank of chairman because, in his own right, he is a very distinguished businessman. He owns his own companies; he runs his own companies; he has been very successful in that regard. He not only has worked in domestic business but he has worked in foreign business. So, he knows it from both sides of the equation. And he is attuned to progress and working to try to solve our problems in a constructive manner. He is not a protectionist.

I don't want to take any further time. But, Mr. Chairman, it is a real privilege to introduce to this panel and to the Congress Mr. Frank Morsani, the chairman of the U.S. Chamber of Commerce.

Chairman **LaFalce**. Thank you very, very much, Sam. We look forward to hearing from your friend and constituent.

Mr. **Gibbons**. If you don't mind, I will sit and listen for a while.

Chairman **LaFalce**. You can sit around and listen. You can do anything you want to.

Mr. **Gibbons**. You will hear from me enough without me testifying.

Chairman **LaFalce**. Our first witness is going to be Ms. Paula Stern, the Chairperson of the International Trade Commission.

I say to Paula and to the other witnesses that we will introduce the entire text of your remarks in the record, and you may feel free to either read them or summarize them, if that is your desire. We ask each of you to try to keep your remarks to about 10 minutes or so, so that the members of the subcommittee can have adequate time for questioning.

Thank you.

STATEMENT OF HON. PAULA STERN, CHAIRPERSON, U.S. INTERNATIONAL TRADE COMMISSION

Ms. STERN. Good morning, Mr. Chairman and members of the committee. It is a pleasure to be here with you today.

There is increasing evidence, as you, Chairman LaFalce, have said, that manufacturing industries face severe and growing pressure from foreign competition. This pressure has increased both during the worst economic recession in decades, and also during the vigorous expansion out of those depths.

How could that have occurred, and of what relevance is it for trade relief? I will first address the broad topic of how macroeconomic policies have been responsible for this situation, and then I will turn to the narrower topic of how the pressure is reflected in the caseload at the International Trade Commission and what implications I see for the application of trade relief.

Before I launch into it, I should state that I am speaking for myself based on my 7 years at the Commission.

The recent recessionary period stretching from the close of 1979 through the end of 1982 was fundamentally different from previous postwar recessions—not only in length and depth, but also in a monetary policy which helped produce record high interest rates and a sky-high dollar. As a result, the normal cyclical pattern of import competition was broken.

Manufactured imports, rather than declining, held their own in the struggle over market share with U.S. producers, thereby those manufacturing imports entered the present recovery with a much stronger foothold. The present recovery is also fundamentally different. The normal pattern of import gains during growth continues; that is normal and typical for postwar recoveries. But it is on top of a base that failed to contract in the recession.

An unusually expansive fiscal policy for a recovery period has resulted in huge and escalating budget deficits, while both our fiscal and our monetary policy mix continues to keep the dollar high, further boosting imports and hurting exports.

The single most effective factor affecting trade has been the strength of the dollar since 1980, which has rendered the entire economy vulnerable to imports. At the beginning of March of this year, the dollar was up 93 percent over its July 1980 low. There have been downward fluctuations since then, but the strong dollar has become a pervasive fact of our economic life and now ranks with the two great oil shocks in terms of its profound effect on our economy.

So we have a new phenomenon—pressure for import relief in the United States that is lasting well into the present period of economic growth. Usually our caseload should go up when we are having a recession, but our caseload has been going up in this so-called period of recovery.

The increased demand for trade relief is clearly reflected in our caseload at the Commission. We currently face an avalanche of requests for relief. From the recession year of 1981 to the so-called recovery year of 1984, our caseload grew by 88 percent. During May 1985, the Commission had active a total of 100 investigations. Thus far in fiscal year 1985, we have initiated 165 new investigations compared with 136 in the same period of fiscal year 1984. And we have completed 175 investigations thus far in fiscal year 1985 compared with the 128 cases we completed in the same period of fiscal year 1984—and 1984 was a record over the year before that.

Based on my 7 years of experience at the Commission, I would like to offer some observations on proposals that have been discussed to improve the effectiveness of the import relief system. I will discuss the concept of conditionality, or the provision of assistance to an industry in exchange for specific actions by management and labor. And I will talk about what to do with industries that might be prime candidates for relief programs, but which don't meet the requirement under current law that imports be the principal cause of their problems.

I believe section 201 of the Trade Act offers a reasonable approach to the problems of declining industries. It provides a middle ground between extreme alternatives most of us would find undesirable or unacceptable. On the one hand, artifically maintaining jobs in declining industries by permanent trade restrictions would impose unacceptable costs on consumers, remove the beneficial effects of competitive pressures on U.S. businesses, and ignore the fact we are increasingly operating in a dymanic world economy.

On the other hand, a policy of strict nonintervention would require asking our elected officials to ignore the substantial and often painful displacement of U.S. workers associated with significant import competition.

The middle ground, represented by section 201, is that of promoting adjustment by the industry during periods of temporary protection from imports. Unfortunately, we suffer from a lack of a consensus on exactly what constitutes adjustment.

In my observation, adjustment to foreign competition usually includes a combination of two elements: modernization and contraction. Most petitioners before the Commission stress the former, the modernization. In discussing their plans for change, they emphasize productivity enhancing investments and new marketing strategies designed to eliminate their cost disadvantage relative to their foreign competition.

Such efforts are, after all, the essence of this breathing space argument. Much less attention is paid to the latter element, to any contraction that the industry may have to undergo. Yet, economic logic suggests that if comparative advantage has shifted to low-cost foreign producers, an important aspect of adjustment will entail a reduction in capacity with the shrinking labor force. In such situations, good policy would make the adjustment to the smaller yet more competitive industries more orderly and less painful for the firms and the workers and communities dependent on them.

Contraction will not always require a reduction in the capacity of that industry to produce, but contraction will inevitably and invariably necessitate the loss of jobs in that industry. Thus, effective adjustment must provide for the orderly and efficient transition of workers into other forms of employment.

Quite frankly, discussions of industrial contraction and reduced employment are not enjoyable political fare. Nevertheless, it is a reality that is best dealt with in a straightforward manner.

In closing, I would like to offer several comments on the advisability of placing greater emphasis on industry adjustment in the relief process. First, the discussion of conditionality is a healthy development because this concept acknowledges that imports are usually not the only problem confronting ailing domestic industries. Import relief alone will not directly solve problems related to poor investment and marketing decisions, or to high cost structures or to declining demand for the product of the industry. Conditioning import relief offers the possibility of more comprehensive solutions to the problems of declining industries.

Second, import injury tests may prevent the use of section 201 by many declining industries. Perhaps other forms or remedies should be considered in those instances. Import relief cannot be expected to remedy the difficult economic problems resulting from the macroeconomic policies of the last several years. And Congress may wish to provide for the possibility of adjustment packages which are not necessarily contingent upon import relief.

Third, as we seek to develop more precise tools to promote adjustment in section 201, we must accept the fact that the adjustment for many industries will require a smaller work force and fewer plants. An effective program of worker retraining and relocation should be an integral part of many industrial adjustment programs. The expiration of the Trade Adjustment Assistance Program at the end of the fiscal year will soon offer Congress the opportunity to debate this issue.

Another approach was taken in last year's Trade and Tariff Act in which Congress required the steel companies to provide retraining for their workers in exchange for negotiated limitations on imports.

My fourth and final observation deals with the role of the Commission in attempts to improve the effectiveness of import relief. The statutory requirement that we compare imports to other possible causes of injury gives us at the Commission expertise on all of the major problems confronting a declining industry that comes before us. I am sure that our expertise is one reason we have been given an important role in monitoring this new Steel Import Relief Program, which was provided for in last year's Trade and Tariff Act.

While I firmly believe that our elected officials should have a major role in shaping the components of any adjustment package, I think that we at the Commission can still be used in our role as an industry assessor.

Now, my discussion has focused on restoring the international competitiveness of U.S. industries, but we must acknowledge there is significant constraints that will frustrate even the most effective relief program. For example, a dilemma is presented when the product in question is an input used by other U.S. businesses. As the copper case last year illustrated, relief for one industry may harm the competitiveness of downstream users of that product.

Another significant constraint on the use of import relief is the reaction of our trading partners. Under international rules that we are abiding by, countries affected by our trade barriers can retaliate by erecting their own barriers. In fact, this was the response of the European Economic Community when President Reagan imposed quotas on specialty steel imports a couple years ago.

Thus, an effective program of industrial adjustment, if it contains import restrictions, will thereby transfer the burden to other U.S. industries in the form of higher costs and also potentially in the form of lost foreign markets.

I thank you very much for your attention, and I will be happy to answer any questions you have.

Chairman LAFALCE. Thank you. That was terrific testimony.

[Ms. Stern's prepared statement follows:]

PREPARED STATEMENT OF PAULA STERN, CHAIRPERSON, U.S. INTERNATIONAL TRADE COMMISSION

IMPORT RELIEF AND INDUSTRIAL COMPETITIVENESS

Good morning Mr. Chairman and members of the committee. It is a pleasure to testify before you today.

There is increasing evidence that manufacturing industries are facing severe and growing pressure from foreign competition. This pressure has increased both during periods of the worst economic recession in decades and during the vigorous expansion out of those depths. How could that have occurred and of what relevance is it for trade relief? I will first address the broad topic of how macroeconomic policies have been responsible for this situation. Then I will turn to the narrower topic of how the pressure is reflected in the caseload of my Commission and what implications I see for the application of trade reflief.

The recent recessionary period stretching from the close of 1979 through the end of 1982 was fundamentally different from previous post-war recessions -- not only in length and depth, but also in a monetary policy which helped produce record high interest rates and a sky-high dollar.

The result: the breaking of the normal cyclical pattern of import penetration. Manufactured imports, rather than declining, held their own in the struggle over market share with U.S. producers. Vital parts of our industrial backbone, like steel, suffered billion dollar losses. And across the board, imports entered the present recovery with a much stronger foothold.

Consequently, the present recovery is also fundamentally different. The normal pattern of import gains during growth continues, but on top of a base that failed to contract in the recession. An unusually expansive fiscal policy for a recovery period means a huge and escalating budget deficit, while both our fiscal and monetary policy mix continues to keep the dollar high, further boosting imports and hurting exports.

The huge inflow of foreign capital, triggered by high real interest rates, has prevented the trade imbalance from self-correcting. It has now become a dominant feature of the international trade environment. So we have a new phenomenon: pressure for import relief in the U.S. that is lasting well into the present period of economic growth.

The single most important factor in all this activity has been the strength of the dollar since 1980, which has rendered the entire economy vulnerable to imports. At the beginning of March, in trade-weighted terms, the dollar was up 93 percent from its July 1980 low. Since then there have been downward fluctuations. But the strong dollar has become such a pervasive fact of our economic life that it now ranks with the two great oil shocks in terms of its profound impact. The high dollar is having the following long-term negative economic and political consequences.

First, the burden has fallen on the American agricultural, mining, and manufacturing sectors. U.S. manufacturers now face a 25-percent import penetration rate. To our trading partners, this may not sound like much. But two decades ago only 5 percent of the U.S. market was held by manufactured imports. Compared to Europe, our economy has been slow to internationalize. But the pace is now terrific. This is especially true in our "basic" industries which are also dealing with a fundamental decline in their international competitiveness. The very sectors hurt by the high dollar are those that many elected officials feel are essential to a strong U.S. economy.

Second, because the high dollar gives an advantage to imported goods, market forces encourage more investment overseas and less here. For example, after fighting for years for policies that would lower the dollar, Caterpillar

Tractor Co. is moving more production abroad. This will undoubtedly mean lost business for Caterpillar's traditional U.S. suppliers. Ford, DuPont, Goodyear, and others are joining the trend.

Thus, our so-called "deindustrialization" is in part a result of America's macroeconomic policies -- policies never set with an eye to the trade sector of the U.S. economy. Trade relief cannot possibly correct for these broad deficiencies. Nevertheless, I will be happy to discuss the narrow role that our current relief statutes can play and to make some general observations on changes that may be in order.

Increased demand for trade relief is clearly reflected in the Commission's caseload. We currently face an avalanche of requests for import relief. From recession-year 1981 to recovery-year 1984 our caseload grew by 88 percent. During May of 1985, the Commission had active a total of 100 investigations. Thus far in FY 85 we have initiated 165 new investigations compared with 136 in the same period of FY 84, while we have completed 175 investigations thus far in FY 85 compared with 128 in FY 84. Indeed, our caseload so far this year is exceeding the projections on which our budget request for FY 85 was based.

Our caseload has been growing not just in size but also in the diversity and complexity of the cases brought before us. The antidumping and countervailing duty statutes continue to be our most active areas. During FY 1984 the Commission conducted 151 cases in this area. Although steel and other manufactured products are the most frequent subjects of these investigations, cases involving agriculture, chemicals, and high tech products are also on the rise, reflecting the increased import sensitivity of the U.S. economy across-the-board.

As I have explained, much of the surge in our caseload can be traced to the strong dollar. The steep appreciation of the dollar in the last four years has priced U.S. goods out of foreign markets and has drawn foreign products to U.S. markets. All types of industries and agricultural programs that previously faced little or no serious threat from foreign competition suddenly find themselves turning to us for relief.

The weakness of the industrial sector is reflected in the employment statistics. Unemployment remained at 7.3 percent in April, which is about the same level it has been since last fall. Service industries have accounted for all job growth. Employment in these industries has increased steadily, while in the factories there has been a loss of 132,000 jobs since January. Manufacturing unemployment now stands at 8 percent and is rising. Virtually all of the fall in manufacturing employment has been in the hard goods industries, many in vulnerable ones. Machinery, metals, and textiles have accounted for three-fourths of the manufacturing drop. During a period of increasing imports and stagnating industrial activity we can expect more U.S. industries to make the case that they are injured by imports.

Another indication that U.S. import-competing industries will be facing increasing competition in the future comes from the Bureau of Labor Statistics. Prices of merchandise imports fell by 3.9 percent from March 1984 to March 1985, with more than half of the fall occurring in the first quarter of this year. During that quarter prices of imports of crude materials fell by 5.0 percent, chemicals by 1.4 percent, intermediate manufactured products by 2.7 percent, machinery and transportation equipment by 1.5 percent, and miscellaneous manufactured products by 3.0 percent. On average, prices of imported merchandise other than fuels fell by 2.2 percent.

Many believe that our existing tools to deal with these problems are inadequate to the task. Too often, the argument goes, U.S. consumers bear the costs of protection in the form of higher prices, while protected industries do not become more competitive; rather, they become dependent on import relief as a means of survival. Far from providing a "breathing space", they argue, import relief has often turned out to be "nap time" for the industry.

My almost seven years at the U.S. International Trade Commission have provided me with considerable experience in the trade problems of U.S. industry. Because we are confronted with the difficulties faced by American firms in international competition on a daily basis, I am able to offer some observations on proposals to improve the effectiveness of import relief. In my analysis, I will include the concept of conditionality, or the provision of assistance to an industry in exchange for specific actions by management and labor in the protected industry. I will also touch upon the notion that some industries may be prime candidates for relief programs, but would probably not meet the requirement of current law that imports are the principal cause of their problems.

I will begin with a discussion of section 201 of the Trade Act of 1974. This statute deals with structural adjustment and is most relevant to discussions of the relationship between import relief and competitiveness.

Section 201 cases draw the greatest attention of all the work done by the Commission. Section 201 does not require the finding of an unfair trade practice. The ITC legally determines whether increasing imports are a substantial cause of serious injury to a domestic industry. If there is such injury we then find what increased duties or quantitative restrictions will remedy that injury or, alternatively, whether adjustment assistance can effectively remedy it. The Commission's advice is forwarded to the President, who determines whether or not to implement it based on policy and political considerations.

Since passage of the 1974 Act, the Commission has completed action on 54 section 201 cases. Of these, the Commission has made affirmative injury determinations and forwarded remedy recommendations to the President in 31 cases. Relief has been provided by the President in 16 of these cases. We are just completing work on our fifty-fifth case -- an investigation of the footwear industry. The Commission found injury from imports and will soon forward a recommendation of quotas to the President.

In just the last two and one-half years we have had nine section 201 cases. In 1983, the specialty steel and motorcycle industries each succeeded in obtaining significant programs of import relief. With one eye on the success of these two industries and the other on the political calendar, five other domestic industries filed petitions in late 1983 and early 1984. For three of these industries -- flatware, footwear, and tuna -- increased imports were not found to be a substantial cause of serious injury. In the other two cases -- copper and carbon steel -- the President rejected our recommendations. However, the President has promised the steel industry relief through "voluntary" restraint agreements and self-initiated unfair trade practice cases. In 1985 the Commission has so far handled two 201 cases; the footwear industry as I explained and the potassium permanganate industry in which imports were not found to be the cause of injury.

I believe section 201 offers a reasonable approach to the problem of declining industries. It provides a middle ground between extreme alternatives that most of us would find undesirable or unacceptable. On the one hand artificially maintaining jobs in declining industries by permanent trade restrictions would impose unacceptable costs on consumers, remove the beneficial effects of competitive pressures on U.S. businesses, and ignore the fact that we increasingly operate in a dynamic world economy. On the other hand a policy of strict nonintervention would require asking our elected officials to ignore the substantial and often painful displacement of U.S. workers associated with significant import competition.

The middle ground represented by section 201 is that of promoting adjustment by the industry during periods of temporary protection from imports. Unfortunately, we suffer from a lack of a consensus on exactly what constitutes adjustment, and I believe this is a key issue to any discussion of conditionality.

Adjustment to foreign competition will usually include a combination of two elements: modernization and contraction. Most petitioners stress the former. In discussing their plans for change, they will emphasize productivity-enhancing investments and new marketing strategies designed to eliminate their cost disadvantage relative to their foreign competitors. Such efforts are, after all, the essence of the "breathing space" argument.

Much less attention is paid to the latter element -- to any contraction that the industry may also have to undergo. Yet economic logic suggests that for many of our industries which have seen the comparative advantage shift to low-cost foreign producers, an important aspect of adjustment will entail a reduction in capacity with a shrinking labor force. In such situations, good policy would make the adjustment to a smaller yet more competitive industry more orderly and less painful for the firms, workers, and communities dependent on them.

Contraction will not always require a reduction in the capacity to produce, but it will invariably necessitate the loss of jobs. Any successful effort to modernize to remain competitive must entail increased productivity and, unless output expands sufficiently, there will be fewer jobs in that industry. Thus, effective adjustment must provide for the orderly and efficient transition of workers into other forms of employment.

Discussions of industrial contraction and reduced employment are frankly not enjoyable political fare. Nevertheless, it is a reality that is best dealt with in a straightforward manner. Consider the recent experience with import protection for the auto industry. The domestic industry has benefited from Japan's voluntary restraints on its auto exports for the last four years. A huge investment program was undertaken. Yet, even though the VRA and a strong recovery helped boost sales and profits for U.S. auto producers, the industry has still cut capacity and reduced its labor force, particularly nonproduction workers, during this restraint period. This is the basis for industry's optimism about the future competitiveness of the auto industry.

In contrast to our reluctance to discuss industrial contraction, Japan and Europe appear to be more comfortable with the notion. They face up to the fact that surplus capacity is a problem facing many declining industries, and their adjustment policies are directed at correcting it. But even though many of our advanced competitors seem to be able to plan for contraction more openly, they often encounter serious political difficulties in implementing it. Even their coordinated efforts to cut back can prove inadequate.

In closing I would like to offer several general comments on conditionality and the advisablity of placing greater emphasis on industry adjustment in the relief process.

First, the discussion of conditionality is a healthy development because this concept acknowledges that imports are usually not the only problem confronting ailing domestic industries. Import relief alone will not directly solve problems related to poor investment and marketing decisions, high cost structures, or declining demand for the product of the industry. The fact that three of the five section 201 cases that we had in 1984 were filed by previous beneficiaries of import relief strongly suggests that more finely tuned instruments to promote adjustment are needed. Conditioning import relief with these considerations in mind offers the possibility of more comprehensive solutions to the problems of declining industries.

Second, while section 201 is the most likely vehicle to implement conditionality, the injury test may prevent the use of section 201 by many declining industries. Specifically I am referring to the requirement that imports be at least as important as any other cause of serious injury before relief can be recommended. Although I was in the minority, my views on the steel case suggested that the steel industry did not qualify for relief under section 201. In the auto case in 1980, the majority of the Commission found that, although the industry was seriously injured, imports were not the most important cause of that injury. Yet both the steel and auto industries were prime candidates for adjustment packages under most formulations of conditionality. Perhaps other forums or remedies should be considered in these instances. Import relief cannot be expected to remedy the economic difficulties resulting from the microeconomic policies of the last several years and Congress may wish to provide for the possibility of adjustment packages not contingent on import relief.

Third, as we seek to develop more precise tools to promote adjustment in section 201, we must accept the fact that adjustment for many industries will require a smaller workforce and fewer plants. I can think of two specific applications of this concept. One is that an effective program of worker retraining and relocation should be an integral part of many industrial adjustment programs. Import relief by itself may offer a false hope to those unemployed workers whose jobs may be lost forever to foreign competitors. The expiration of the Trade Adjustment Assistance Program at the end of this fiscal year will soon offer Congress the opportunity to debate this issue. Another approach was taken in last year's Trade and Tariff Act, in which Congress is requiring the steel companies to provide retraining for their workers in exchange for negotiated limitations on imports. In effect, this requirement represents the "privatizing" of trade adjustment assistance.

Another application deals with investment policy. Many proponents of conditionality argue that a protected industry should be required to reinvest its profits back into the industry. Indeed, this is a part of the national policy for the steel industry included in the 1984 Act. This reflects the general concern with current modernization efforts. However, while investment policy may be an appropriate part of a comprehensive industrial adjustment program, a policy of reinvestment in declining product lines may be inappropriate and counterproductive for many industries. In some instances, the appropriate adjustment strategy for an industry may be investment in new kinds of production processes or a shift into more specialized products for which it retains a comparative advantage.

My fourth observation deals with the role of the Commission in attempts to improve the effectiveness of import relief. During our section 201 investigations we collect much data and information on the condition of the domestic industry and its efforts to compete with foreign producers. The statutory requirement that we compare imports to others possible causes of injury gives us expertise on all of the major problems confronting a declining industry. Thus I believe we have much to offer in providing a more detailed analysis of domestic industries and in designing broader adjustment packages. I am sure that our expertise is a major reason why we have been given an important role in monitoring the new steel import relief program. While I firmly believe that our elected officials should have a major role in shaping the components in any adjustment package, I think much use can still be made of the Commission's role as an "industry assessor."

I would like to make one final point. My discussion thus far has focused only on improving the effectiveness of import relief measures in restoring the international competitiveness of U.S. industries. But we must acknowledge significant constraints that will frustrate even the most effective relief program. For example, in all of our cases we hear of the potential impact on consumers of any new protection. An additional dilemma is presented when the product in question is an input used by other U.S. businesses. As the copper case illustrated, relief for one industry may harm the competitiveness of downstream users of the product.

Another significant constraint on the use of import relief is the reaction of our trading partners. Under international trade rules, countries affected by our trade barriers can retaliate by erecting their own. In fact, this was the response of the European Community when President Reagan imposed quotas on specialty steel imports.

Thus, an effective program of industrial adjustment, if it contains import restrictions, may merely transfer the burden to other U.S. industries in the form of higher costs and lost foreign markets.

Thank you. I will be pleased to answer any questions.

Chairman **LaFalce**. We are going to withhold our questions until we have had the opportunity to hear from the other witnesses.

We will now hear from Mr. Frank Morsani. Some people know him as the chairman of the board of the United States Chamber of Commerce, but his primary import, as we all know, is that he is a constituent of Sam Gibbons.

Mr. Morsani.

STATEMENT OF FRANK L. MORSANI, CHAIRMAN OF THE BOARD, CHAMBER OF COMMERCE OF THE UNITED STATES OF AMERICA

Mr. **Morsani**. Thank you.

Good morning, Mr. Chairman, members of the subcommittee. This is my first appearance before Congress since becoming chairman in April.

I am especially pleased that my Congressman, Sam Gibbons, has accompanied me here on this occasion. Sam and I have been friends for many years. I have tremendous respect for his views and especially on this subject of trade. We have little differences. In my opinion, he exemplifies what a representative really should be in our Nation.

Chairman **LaFalce**. Mr. Morsani, just so you don't get any type of inferiority complex, we would have invited you even if you weren't Sam's constituent.

Mr. **Morsani**. Thank you.

It is no coincidence I have chosen to address the trade issue today. It is a vital issue that deserves increased attention from all of us: business, labor, Congress, the administration, academia, and indeed the general public. And your subcommittee has held extensive hearings on economic and trade issues since the 99th Congress convened, and you have heard an impressive array of witnesses present outstanding testimony.

In your announcement of this hearing, you have raised some fundamental questions. My prepared statement attempts to respond to them. I know that you have nagging frustrations when your constituents—the auto worker in Michigan, the steel worker in Ohio or Pennsylvania or New York, the textile worker in the Southeast ask the tough question: "What can you do to help me?"

For them, statistics are not enough, and perhaps what I say will not be enough, and maybe what I have submitted for the record will not be enough. I do not pretend to be an expert on all aspects of international trade; rather, I come to you to pledge the full support of the U.S. Chamber and its resources to deal with the problem.

There has been no shortage of congressional responses to what is seen as a slippage of America's position in world markets. Congress has passed two nonbinding resolutions urging the President to get tough with the Japanese. A textile bill has over 285 cosponsors in the House and 50 cosponsors in the Senate. And my own friend and Congressman, Sam Gibbons, has introduced a natural resources subsidy bill, and many——

Chairman **LaFalce**. He has received so much acclaim for that, Canada has made him an honorary citizen, I just want you to know.

Mr. **Morsani.** Taken individually, these measures are well-intentioned and may appear to be harmless. But so was the Smoot-Hawley Tariff Act when it was introduced. My fear is, if we are not careful, we will again suffer the fate of the 1930's when a catastrophic worldwide depression occurred.

What can we do to improve our trade posture? The first thing is to take stock of how we got here and to dispel some of the cliches and misconception that have sprung up around the issue.

Until a decade ago, we were living with the luxury of a trade surplus, but we were shocked out of this complacency in the early 1970's by the OPEC oil embargo, which led to sky-rocketing petroleum prices, as we all know. The trade deficit zoomed, and even today petroleum imports account for 25 percent of our trade deficit.

That trade deficit has continued to grow, and there are many reasons for it, including our massive Federal budget deficit and the strong dollar. Much is being said about these two problems, so I need to add a little at this time.

Some argue that the strength of the dollar is forcing deindustrialization in America. I would dispute that view. While we have had many ups and downs within various industrial sectors, since 1980 the United States has out-performed all, but Japan, of the seven industrialized nations in terms of production.

Another bogeyman is the so-called Japanese issue. But consider our neighbors in Canada. We share a common border, a border adjacent to many of the States represented on this subcommittee, and a common language, and in many respects a common culture. Yet, our trade deficit is $21 billion, significantly higher than with Japan on a per capita basis.

Perhaps we should look more deeply within ourselves. In our businesses, I tell my employees not to waste their time worrying about the competition in the areas in which we operate, but be the competition. And in the communities we operate around the country, we are the competition.

In my view, America needs to learn how to become world traders again. We must become students of other cultures. Something as basic as learning another language can go a long ways toward putting us on a more competitive footing with our rivals.

They have taken great pains to design products and sales tactics for our markets. When we address cultural problems, we even have regional problems within our own country. In fact, in your fair city in 1955, I was a welder on pipelines and was fired because I was Italian.

Chairman **LaFalce.** We are going to have to talk about that.

Mr. **Morsani.** I agree, we are.

So the people I was working with on the line say, "Generally, we don't go on welfare until the first of November." And I said, "Well, I think I will have a job by 7 o'clock in the morning." I was working in White Plains, NY, the next morning at 7 o'clock.

Chairman **LaFalce.** Where were you working, and on what project?

Mr. **Morsani.** We were piping Lancaster, North Tonawanda for natural gas.

Chairman **LaFalce.** That is in my district. As an Italian-American Congressman, I am especially interested.

Mr. **Morsani**. Cultural problems are as major a problem with trade as those statistic and economic problems.

Let me close, Mr. Chairman, by pointing out that some sages say protectionism is a word used to blame your problem on someone outside your congressional district—and the further outside, the better. But protectionism at home is ultimately self-defeating. It divides a smaller pie instead of expanding that pie. It deprives Americans of high-quality goods at lower prices, and ultimately deprives American businesses and their workers of opportunities because of retaliation abroad.

The problem requires more than politics as usual. It requires the best efforts of all of us to put our shoulders to the wheel. And I compliment you again on beginning to tackle the issue.

We remain eager to assist this subcommittee and Congress to keep America growing by expanding possibilities for trade around the world.

I thank you for your attention and for being here. I also will be glad to respond to your questions when asked.

Chairman **LaFalce**. Thank you very much, Mr. Morsani.

[Mr. Morsani's prepared statement, on behalf of the Chamber of Commerce of the United States, follows:]

STATEMENT
on
THE GROWING CLAMOR FOR PROTECTIONISM
before the
SUBCOMMITTEE ON ECONOMIC STABILIZATION
of the
HOUSE COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS
for the
CHAMBER OF COMMERCE OF THE UNITED STATES
by
Frank L. Morsani
June 26, 1985

Mr. Chairman, members of the Subcommittee, I am Frank L. Morsani, Chairman of the Board, Chamber of Commerce of the United States of America. I am also President of Precision Enterprises in Tampa, Florida.

Introduction

We congratulate the Chairman and members of this Subcommittee for convening this hearing. We are well aware of the frustration that you feel concerning increased U.S. trade deficits and unfair foreign trade practices. The growing clamor for protectionism, as you have so aptly characterized it, continues to rise with every passing month, despite passage of major trade legislation last fall. Left unchecked, protectionist tensions threaten to undermine and possibly destroy the multilateral trading system that has served to promote world trade and economic growth since World War II.

A number of factors have contributed to the rise of protectionism. Uneven economic growth worldwide, high unemployment in some areas, volatile exchange rates, and government market intervention, as well as unavoidable structural changes in the world economy, have all fueled dissatisfaction with the current system. But by closing our markets to foreign competition, we would bring about results all of us should fear. If those who call for restrictions, here and abroad, retain the offensive and obtain the market-closing policies they seek, we will risk a worldwide collapse of trade that could be worse than the Great Depression of the 1930's. If this should occur, the overall health of our relationships with other nations stands to deteriorate. All segments of the American public, including the Administration and Congress, as well as business, labor and academia, must recognize this and begin to grapple with this challenge.

The domestic U.S. economy is increasingly integrated with the world economy. The percentage of the U.S. economy accounted for by exports and imports has doubled over the last twenty years. It is now over 20% of our Gross National Product. Greater interdependence is obvious in trade, finance, investment and technology.

In short, our trade interests are inseparable from not only our domestic interests but also our diplomatic, strategic and military interests abroad. Disruption in any one of these areas threatens stability and progress in all of them.

Numerous examples abound: for example, President Reagan's announcement of his intention to embargo trade with Nicaragua not only raised new questions about the renewed use of trade as a weapon but also brought into focus a new disagreement between us and our allies on U.S.-Central American policy, a major foreign policy issue.

Against the backdrop of continuing record U.S. budget deficits, the U.S. and its allies find themselves unable to agree on the purpose of international monetary talks or even to set a date for multilateral trade negotiations.

And, as we all know, the 1974 OPEC oil embargo and resultant price increases and dislocations made the average American realize, perhaps for the first time, that we can not ignore the world economy. Even today, petroleum imports account for 25% of our trade deficit. We are as dependent on "them" as "they" are on "us."

As we meet the trade challenge, we must not forget that.

America's Challenge

U.S. international economic performance is at a crossroads. The $123 billion merchandise trade deficit for 1984 has brought into clear focus a potentially dangerous situation that has been developing for some time. Since World War II, with the advent of U.S. world trade leadership, we have viewed ourselves as second to none. Left largely unscathed at home by the ravages of WWII, America's leadership in world affairs seemed unchallengeable. We assumed leadership in drafting the multilateral trade order known as the General Agreement on Tariffs and Trade (GATT) which took effect in 1948. The seven major rounds of trade negotiations under GATT auspices are principally responsible for the widespread and substantial reductions in tariffs worldwide.

The United States has also played a leading role in global finance and development affairs. In 1944, at Bretton Woods, New Hampshire, a U.S.-led conference of forty-four nations agreed to establish two international institutions for the purpose of promoting a stable, peacetime global economic environment. The International Bank for Reconstruction and Development (also known as the World Bank) was established for the purpose of making long-term reconstruction and development loans. With over 140 member nations, it is the world's largest single aid donor, as well as the largest borrower in the international bond market. Its development mission, made possible by the Marshall Plan, has reached around the world. The International Monetary Fund (IMF) is charged with the provision of short-term assistance (loans) to countries with balance-of-payments problems. Through its efforts to promote international monetary cooperation and stability, the IMF seeks to facilitate the expansion of trade and, in turn, increase world employment and economic growth.

Both institutions, while not without problems, clearly represent the best intentions and leadership abilities of the United States. As leaders, in business and in government, we must to continue this traditon. We must ensure that the substance of our leadership truly reflects the aspirations of humanity--freedom, opportunity, peace, and prosperity.

However, our leadership is under challenge as never before. The continuing evolution of the world economy and the dislocation it is causing are leading many Americans to question the very foundations of the world economy and the trading system which we have helped to shape. The advantages we enjoyed relative to other nations when the GATT system was formed have all but disappeared as other nations have developed. In many cases, rules which were intended to help them when they needed help now provide them with significant advantages. More often than in many years, Americans are viewing the world trade and financial system as a threat to their well-being, rather than an opportunity. They see the U.S. trade deficit reaching record levels. They see the shift in emphasis from manufacturing to services and high-technology but have doubts about its future. They see developing countries attempting to cope with their indebtedness but view the IMF as an agent of big-bank bailouts.

The observation that the U.S. is rapidly becoming the world's largest debtor nation frightens many Americans. Massive international capital flows in the direction of the U.S. have helped to finance the U.S. budget deficit and other credit needs. It is important to note that while annual inflows of foreign savings have remained relatively stable since 1981, net U.S. capital outflows have fallen significantly. In other words, a major factor underlying overall capital inflows into the U.S. is the decline in U.S. capital leaving the U.S., and not a major increase in foreign savings in the U.S. Nonetheless, there is concern among many that someday, under as yet unforeseeable circumstances, overall capital flows may reverse direction, out of the U.S., greatly increasing the cost and difficulty of financing U.S. credit and investment needs.

In short, the world trade and financial system suffers a crisis in confidence where confidence may matter most--here in the United States. And we have yet to formulate a policy to restore this confidence.

Protectionist Trends

These concerns are not new. We have seen them before. The Smoot-Hawley tariff of 1930 started as a relief measure for agricultural products. Yet, it became the most protectionist legislation in American history. Numerous amendments were adopted, and tariffs were raised to record levels. Much of the world retaliated, and all of us paid with a longer and deeper Great Depression.

International financial institutions are not free from controversy and criticism either. Two years ago, Congress narrowly averted serious problems when it agreed to pass IMF quota increase legislation. That legislation substantially increased confidence in the IMF to address what many regarded as the worst international financial crisis since the 1930's. Passage of this legislation was not without rough sailing, however. Many Americans expressed understandable but misplaced fears that the quota increase would be abused to cover past bank management failings. In response to these fears, new constraints to check such abuses were adopted.

We can cite numerous examples of departures from free trade. Nations around the world engage in elaborate trade-distorting practices. Japan's use of countless, complex non-tariff barriers is legendary, accounting for an estimated $10 billion of their trade surplus with the United States. The Europeans' use of agricultural export subsidies poses a major problem for the farm sector and, as much as anything else, undermines our efforts to achieve harmonious trade relations with the European Economic Community. The less developed countries and the newly industrialized countries find themselves forced to subsidize their manufactured and raw material exports in order to obtain foreign exchange and service their debt. At the same time, their domestic political situation makes it difficult for them to provide market access anything like our own.

In the United States, the last recession served to increase resentment of foreign imports enjoying substantial market share while Americans were being laid off. The increasing importance of the service and "high-tech" sectors relative to manufacturing and stronger foreign competition in both areas have highlighted the importance of adjustment, as well as the clamor for protectionism that results.

And perhaps most important of all, the wild fluctuations in exchange rates, including a substantial appreciation of the dollar in the last five years against major currencies, have posed important challenges for U.S. industry. Many U.S. exporters and import-competing companies correctly blame the strong dollar for a major decline in their ability to compete. In addition, the instability of exchange rates, regardless of the actual ratio, introduces new uncertainty and risk into business decision making. This brings higher costs, inflationary pressure and greater market concentration.

Trade Policy from the 1930's to the Present

Beginning with the enactment of the 1934 Trade Agreements Act, the U.S. government has commendably taken a number of steps which recognized the folly of protectionism and worked to open the trading system. Pursuant to the spirit and letter of GATT, Presidential flexibility to reduce trade barriers and negotiate trade agreements under GATT was enhanced. Under the Trade Act of 1974, less developed countries (LDCs) were granted duty-free access to the U.S. market under the terms of the Generalized System of Preferences. The Tokyo Round of trade negotiations achieved agreement on several non-tariff issues. Congressional passage of the 1979

Trade Agreements Act served to implement these agreements. At the same time, Congress did what it could to make sure that unfair practices, such as dumping and subsidies, remained subject to sanctions. A process of relief from injurious imports, as well as from a potentially wide range of unfair foreign trade practices, was included in Sections 201 and 301 of the 1974 Trade Act.

In 1984, the last significant trade legislation, the Trade and Tariff Act, was enacted. The managers of this legislation, in particular including my own Congressman, Sam Gibbons, should be commended for their efforts to maintain and strengthen the trading system. Renewal of GSP is vitally important to the maintenance of mutually beneficial trade between the U.S. and less developed countries. Equally important, the so-called reciprocity provisions in Title III provide important new tools for the President to negotiate for greater U.S. trade and investment access to foreign markets. However, the 1984 Act is at least as notable for what is not in it as for what is in it.

Current Problems

While the 1984 Act represents a tentative victory for open trade forces, the strong continuing dissatisfaction with U.S. trade performance has led to the introduction of numerous trade proposals in the 99th Congress. Some of these proposals closely resemble provisions seriously considered but set aside by the 98th Congress as it debated the 1984 Act.

I do not doubt that Congress will soon place trade issues at the top of its legislative agenda. Anyone who even glances at a newspaper or watches TV can see that trade is a major issue. The consequences of Congressional action will be important and may be far-reaching. Therefore, it is imperative that all who are involved in trade policy distinguish fact from fiction when identifying issues and considering responses.

For example, Americans increasingly single out Japan as the principal, if not the sole, villain against whom we must prevail in the world market. Japan's $37 billion trade surplus with the United States, it is said, is principally the result of countless trade-distorting practices developed through government-industry collusion. Regardless of their actual impact, these practices are unbefitting a highly developed nation. Unless Japan quickly eliminates these practices, they may find access to the U.S market denied or sharply restricted.

There is no question that Japan's markets are effectively closed to many foreign enterprises. We recognize that culture and tradition (e.g., "keiretsu") play an important role in determining strong Japanese preferences for domestically produced goods. However, Japan must take meaningful action now to open up its markets to a degree comparable to the access we provide to U.S. markets. This includes sales of goods and sevices, as well as investment. Failure to take these steps now will only worsen the political climate between our countries. Left unattended, the deterioration of relations between our countries will soon reach the point of no return. Once that happens, both sides will likely enter a downward spiral of retaliation, recrimination and stagnation in which everyone loses.

We Share Responsiblity

Nonetheless, we should not overstate the significance of Japanese trade barriers or their relationship to the trade deficit, irritating though these may be. The fact of the matter is that the major portion of the so-called "Japan problem" is made right here in the U.S.A. If Japan were to eliminate all of its trade distorting practices overnight, optimists estimate that our bilateral trade deficit would be reduced by about $10 billion--less than one-third of the total. The unpleasant truth is that, regardless of questionable Japanese trade practices, the U.S. business community needs to improve its performance in many ways. Let me make some observations about the relative state of Japanese and U.S. industry:

— Japanese manufacturing productivity has risen almost three times faster than that of America since 1970.

-- The Japanese savings rate is much higher than the U.S. rate. The excess of Japanese savings over domestic investment is "exported" to other countries, keeping the yen's value down without deliberate currency manipulation. The result is greater price-competitiveness of Japanese exports.

-- The Japanese capital stock has been growing over twice as fast as the American since 1970. As a result, Japanese equipment is much newer than American equipment.

-- The large increase in the Japanese share of the world market for cars, trucks and ships reflects both cost and quality advantages.

These are important differences which must be narrowed in America. We cannot rightfully expect Japan, or any other nation, not to compete effectively in the marketplace, even though we may insist that they play by the rules. The choice here is largely ours.

It is also worth observing that, on a per capita basis, Japan is not the worst trade offender, if merely sustaining a trade surplus can be called an offense. While Japan, with a population of 120 million, had a $37 billion trade surplus with the U.S. last year, Canada, with only 25 million people, had a $20.6 billion surplus. In other words, on a per capita basis, Canada's merchandise trade surplus with the U.S. was three times as large as Japan's in 1984. And yet, while we talk about punishing Japan with new trade restrictions, we are contemplating free trade areas with Canada. This is simply not fair.

Some believe that the trade deficit or the strong dollar is "deindustrializing" America. The data do not support this. It is true that some firms and industries, such as basic steel and mill products, have declined over the last several years. But other sectors, such as communications equipment and electronic components, have grown impressively. Since 1980, growth in overall U.S. industrial production, at 12 percent, topped that of each of the seven major industrial countries except Japan. Indeed, production in Italy and France, with their weak currencies, actually fell since 1980 while it increased only 2 percent in Britain.

This is not to say that some otherwise highly competitive firms have not suffered over the past few years as a consequence of the sharp appreciation of the dollar. They most certainly have. What we are saying is that in the aggregate, thanks in large part to domestic, growth-oriented tax, budget and regulatory policies, U.S. industrial production has substantially improved, both in absolute terms and relative to most of our major trading partners.

The same point can be made about overall U.S. economic performance. The evidence is clear that, among the seven major industrial countries, those with low-tax/low-spend policies are out performing high-tax/high-spend countries in both employment and output. The solution to what is described as the dollar problem and foreign stagnation lies in a greater convergence of U.S. and foreign economic policies. Specifically, this means foreign emulation of demonstrably successful U.S. economic policies--tax and spending cuts, deregulation and disciplined, non-inflationary monetary policy. In addition, Congress must weigh carefully the ramifications of proposed major changes in the Internal Revenue Code as they affect worldwide savings and investment. Tax simplification proposals, such as "Treasury II," represent the most significant revisions of the tax code in at least a generation. We must remember, again, that our actions in this regard will have repercussions extending well beyond our borders. We urge Congress to keep this in mind as it pursues its deliberations.

While fiscal and monetary policies are important determinants of U.S. international competitiveness, those calling for protection believe that closing off or restricting world trade provides jobs and stimulates growth by insulating industries from an inherently "unfair" and unforgiving market. But history clearly shows us that "insulation" leads to industrial stagnation, wasted resources, fewer jobs and lower living standards. Sluggish growth and increased unemployment in the U.S. and around the world are the inevitable results.

Recommendations

The best trade policy for promoting growth and jobs is one that recognizes our growing interdependence as an opportunity. Such a policy will favor expansion and liberalization of the trading system, not restriction. We must maintain efforts to lower trade barriers abroad and resist pressures to close our own markets. The prospect of severe damage to the trading system resulting from protectionist initiatives makes it even more timely for the Chamber to reaffirm its support for actions that result in trade liberalization worldwide. Our recommendations include the following:

- Effective enforcement of U.S. laws in defense of our trade rights under international rules can help ameliorate growing pressure for counterproductive trade-restrictive measures.

- The Chamber reaffirms its opposition to protectionist measures, such as import surcharges, quotas, domestic content laws and restrictive trade laws in conflict with our international obligations.

- The Chamber supports Presidential use of tools provided in Title III of the Trade and Tariff Act of 1984 in order to obtain increased market access abroad. Restrictive trade barriers in other nations deny U.S. exporters, investors and service firms a fair opportunity to compete. It is difficult for the United States to retain its status as a relatively open market accessible to other nations when equivalent access is not enjoyed by U.S. companies overseas. This is particularly pertinent in the case of advanced developing countries that enjoy duty-free access to the U.S. market provided under GSP but continue to maintain trade-distorting practices and restrictions in their own countries. GSP is important to world trade and it should be continued. But it must not be abused.

- The Chamber also supports new and dedicated multilateral efforts to reduce barriers and to restore and improve discipline and stability in the world trading system. Priorities should include (but not necessarily be limited to) strengthening the disciplines of the international trading system; further reductions of tariff and non-tariff barriers; improvement of the performance of GATT machinery and secretariat; adaptation to the growing concerns surrounding services, investment and intellectual property rights; the linkage of trade and monetary matters; further integration of LDCs into the world trading system; maximizing public support for improvement of present trade rules and institutions; and Congressional renewal of Presidential negotiating authority.

Congress has before it several restrictive proposals aimed specifically at Japan. The prospect of a serious conflict between the world's two most important trading nations deeply concerns the Chamber. We believe that sustained growth and development of commerce in the Pacific basin represent one of humanity's best hopes for the next century. This region, with its rapidly growing, dynamic market-oriented economies, gives every indication that it will assume world economic leadership for the forseeable future. A healthy, vibrant U.S.-Japan relationship in trade and, indeed, in all matters is critical to the success of the region and the world economy.

We recognize that numerous unresolved differences exist between the United States and Japan. Trying to resolve these differences may on occasion cause the U.S. government to take unilateral action which will prod our Japanese friends to be more forthcoming in their efforts to reach agreement.

However, Congress and the Administration must carefully define the problems to be solved, as well as the manner in which they are to be solved. The Chamber's positions in this regard are the following:

- The Chamber opposes legislation that mandates the President to take retaliatory action against any country. The Chief Executive's flexibility as embodied in existing law must be retained. Denial of such flexibility will make targeting responses to specific developments far more difficult, thereby reducing the chances of obtaining the market access or other outcomes we seek.

- The Chamber does believe that on a case-by-case basis the Administration should exert greater leverage, using existing mechanisms of multilateral and bilateral negotiations and agreements. These include Article XXIII of the GATT, the "nullification or impairment" clause. If these efforts fail, then the U.S. should exercise its rights under domestic and international trade laws and consider major changes in existing domestic and international arrangements governing trade.

Let me take this opportunity to tell you about an emerging trade issue on which the U.S. Chamber is taking a leadership role: access to the rapidly growing worldwide telecommunications market. The opportunity to compete fully and fairly in foreign markets is a fundamental objective of the American business community. Nowhere is this more important than in the emerging worldwide high technology markets, particularly those associated with what some call the global information economy, which spans a range of products and services connected with the generating, processing and distribution of information. Computer hardware and software, micro-electronics, and telecommunications technologies are all vital to the operation of the global information economy. Furthermore, rapid technological change is increasingly blurring the demarcation among these segments.

Unfortunately, we must recognize that a key to this global information economy, the national telecommunications markets, remains among the most highly regulated areas of business activity. Because these telecommunications networks must serve as the central transportation system for the global information economy, progress towards greater competitive opportunities in telecommunications is critical to the future growth of trade in high technology products and services. Recognizing this fact, the U.S. Chamber is working closely with members of Congress to help shape constructive legislation that would encourage the negotiation of greater access for U.S. firms to worldwide telecommunications markets. In the absence of such negotiation, the U.S. business community may well be denied the opportunity to compete in this dynamic part of the world economy.

I think it is important to note at this point that the current administration has demonstrated a clear willingness to exercise leverage, including the use of substantial import restrictive measures, in order to secure cooperation from our trading partners on the question of trade liberalization. For example, the Administration took a dramatic step in this fashion last fall when it banned most European steel pipe and tube imports until the end of 1984 in reaction to perceived non-compliance with steel pipe and tube import agreements.

This administration has taken some restrictive measures of a substantial nature even when it is less clear that the purpose of such measures is to promote negotiation or clarification of an agreement. In April of 1983, President Reagan approved a 45 percent increase in duties on imported motorcycles. The President has taken a number of actions to reduce textile and apparel imports, the most recent major action being the U.S. Customs Service's promulgation of the revised "country-of-origin" rules as they related to "substantial transformation" of textile and apparel products in different countries.

The steel quota system currently in effect is even stricter than the Multifiber Arrangement (MFA) on textile and apparel imports. Unlike the MFA, the steel quota system sets a worldwide ceiling for imports. It includes Europe, not just Japan and developing countries. Imports are prohibited from growing more rapidly than the domestic market. Perhaps most significantly, the steel industry can dismantle the system by filing unfair trade practice cases.

The point here is that, if and when Congress begins to debate trade legislation, it should recognize that this administration has clearly been willing and able to use its existing authority to impose trade restrictions in order to cushion a variety of industries from foreign competition. In our view, the record simply does not support the contention that the Administration has been unwilling to use the tools currently at its disposal to remedy injurious or unfair trade practices.

Chamber International Programs

The U.S. Chamber is uniquely situated to work toward increased market access worldwide. Through an extensive network of 53 affiliated American Chambers of Commerce abroad, representing some 60,000 firms and individuals, American business diplomats are engaged in breaking down barriers to U.S. trade, investment and services every day. AmCham presidents, committee chairmen and other American residents abroad meet face-to-face with host country government and business policy makers. Perhaps the most notable current example of such involvement is that of the president of the American Chamber of Commerce in Japan. He and his AmCham colleagues have been at the forefront in advising every U.S. government negotiating team to visit Tokyo over the last year. He has gained such credibility that he was appointed as one of the two foreign business representatives on the new Advisory Committee to the Japanese Ministerial Committee charged with implementing the pledges contained in Prime Minister Nakasone's April 9 statement.

In addition, the Chamber sponsors 14 bilateral business councils bringing some 700 U.S. corporate executives together with their counterparts from key trading areas around the world. For example, just a few weeks ago, together with our India-U.S. Business Council, we held an off-the-record discussion for 40 senior corporate executives with Prime Minister Gandhi of India. This meeting, along with other similar sessions we have held with some 20 heads of state or government in the last 18 months, provides an opportunity to press for improved business conditions for American exporters, importers, investors and service firms. Mr. Chairman, I think we have had a few successes. Some important countries are opening up slowly. But we have a long way to go before we achieve a fair balance of opportunities in the world's trading system.

Later this year, I will lead a ten-member delegation to China to meet with senior officials within that government. We will try to focus attention on the continuing cultural barriers that inhibit expanded U.S.-China trade.

The point is, Mr. Chairman, that the U.S. Chamber is actively involved, day-to-day, in promoting an improved climate for American business around the world. We cannot simply support an open trading system at home without recognizing that we have an obligation to pressure constantly for improved condition for our exporters and investors abroad. We were particularly pleased to note that in the House State Department authorization bill strong new language has been included to task U.S. ambassadors around the world to work toward improved market access. This new directive, if passed by Congress and implemented with aggressiveness, will help reinforce the activist posture already shared by thousands of American business executives.

Conclusion

Mr. Chairman, I would like to conclude my testimony by pointing out that the stakes involved in the clamor for protectionism are difficult to overstate. As I mentioned earlier, our trade interests cannot be separated from our broader domestic and foreign policy interests. When we fail in one area, the others are also at risk. World commerce, as much as anything, is the glue that holds mankind together. Trade with other nations necessarily forces all of us to recognize how important we are to each other, and how much we depend on each other. It is through mutual recognition and mutual dependence that all of us can strengthen the foundation upon which to build a better, freer and more prosperous world.

I have included with my statement attachments explaining in greater detail the Chamber's position on a number of significant international issues, and I ask permission that they be included in the record. I would be pleased to try to answer any questions the members of this committee may have.

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Chamber of Commerce of the United States of America
Washington

Statement on the U.S. Trade Deficit and Industry Protectionism

The outsized U.S. merchandise trade deficits expected in 1984 and 1985 reflect the serious disadvantages faced in the current macroeconomic environment by U.S. businesses in competition with foreign rivals.

The major sources of the U.S. trade deficit are (1) the gap between the strong growth rate here and growth rates abroad; (2) reduced purchases from the U.S. by debtor developing countries; and (3) the strength of the dollar relative to foreign currencies. The deficit does not, however, indicate that U.S. industries are fundamentally weak or that they are being overtaken by unfair foreign competition.

Consequently, protectionist measures, such as an import surcharge, domestic content laws, and restrictive trade laws, are not a proper or effective means for reducing our trade deficit. On the contrary, import restrictions are apt to exacerbate the deficit in the future by further strengthening the dollar and frustrating the overseas recovery that is crucial to the revival of U.S. sales abroad. Particularly counterproductive would be import restraints that would further erode the already impaired ability of indebted developing countries to pay for U.S. exports. Nothing here should be construed as condoning imports to the United States priced below fair value or those benefitting from foreign government subsidy (as defined in applicable trade law), nor as opposition to United States corporations seeking redress under existing law and regulation against such imports.

Although protectionism is the wrong response to our trade deficit, the U.S. Chamber is concerned that, if sustained, the macroeconomic factors that have created the deficit will cause serious world market losses and the contraction of domestic industries that are fundamentally competitive. To prevent this, the U.S. should encourage policies overseas that invigorate foreign demand and support foreign currencies by creating conditions favorable to growth, adjustment, and expanding world trade. A key force for stimulating economic vitality overseas would be the dismantlement of foreign barriers to trade and investment while the U.S. works at the same time to keep its markets open.

November 1984

Chamber of Commerce of the United States of America
Washington

Statement on Bilateral Trade Agreements

The Chamber continues to advocate multilateral negotiations and agreements as the best means to reduce barriers to world commerce, and supports the principle of non-conditional most-favored-nation treatment as a general norm. Bilateral agreements, and any preferential arrangements among countries, should be avoided because they risk the erosion of the multilateral framework that best serves the free flow of trade and trade-related investment. However, exceptions may be justified if it can be demonstrated that bilateral agreements or arrangements are necessary to create momentum for multilateral negotiations for a more open trading system, or if multilateral action is highly improbable within a reasonable timeframe.

June, 1984

Chamber of Commerce of the United States of America
Washington

Statement on Managed Trade

The growing interest in and use of "managed trade" -- a term used to describe explicit or implicit deals between or among governments, with or without the participation of private parties, to limit import shares in a given market -- in general runs counter to the United States' interest in an expanding and open world economy. At the same time, managed trade may be a practical tool for affording to U.S. industries that have demonstrated injury due to fairly-traded imports the temporary import relief authorized by U.S. law and international agreements.

Therefore, the Chamber of Commerce of the United States believes that managed trade should be employed as a tool of import relief solely within the confines of the standards and procedures of the two major trade statutes offering relief from fairly-traded imports, Section 201 of the 1974 trade law (the so-called "escape clause") and Section 204 of the Agricultural Act of 1956.

The Chamber recognizes that efforts to manage trade outside the confines of these statutes nonetheless are apt to continue. If so, in all cases of managed trade for import relief from fair trade or for any other purpose, the process leading to managed trade should be transparent. The President should publish in the Federal Register an Executive Order announcing his intention to consider, negotiate, enter into, or accept an agreement or arrangement with a foreign government or exporter to restrain trade. Similarly, he should by the same means make notification if he has reason to believe that a foreign government or exporter is acting, or plans to act, to restrain its exports to the U.S. market. At the same time, the President should request comments on these actions.

At a later date, the President should publish in the Federal Register the results of any such negotiation or foreign action to restrain trade. At that time, the President should report on the anticipated costs and benefits of the results to the affected U.S. industries, including users of the restrained product, and to consumers. He should also report on the anticipated overall effect of these results on the U.S. economy.

In all cases of managed trade for import relief from fair trade, the link between such relief and action toward industry adjustment should be improved.

All managed trade for the purpose of import relief from fair trade should be limited in duration at the outset. Any renewal of such relief should be made subject anew to the same criteria and procedures identified for first-time import relief.

Chamber of Commerce of the United States of America

Washington

Statement on Proposed General Agreement on Tariffs and Trade (GATT) Round for 1986

The U.S. Chamber of Commerce's position regarding a proposed 1986 General Agreement on Tariffs and Trade (GATT) Round is as follows:

1. The Chamber supports new and dedicated multilateral efforts to reduce barriers and to restore and improve discipline and stability in the world trading system. The nature of the trading world has changed, and protectionist actions have increased sharply since the last multilateral trade negotiations in 1979. Import barriers and other trade-distorting practices have multiplied, often nullifying past agreements. New and better solutions, covering a wide range of possibilities, must now be sought.

2. Greater flexibility in the actual GATT procedures, techniques and negotiating style is needed, due to constantly changing worldwide economic conditions.

3. The convening of a representative GATT Preparatory Committee is overdue and its hard task of agreeing on an agenda and the means of pursuing its goals must begin. A disciplined and more stable international trading system will require this initial consensus among nations, developed and developing alike, on what must be sought and how.

The Chamber believes that the priorities for these new efforts are at least sevenfold: (1) to strengthen the disciplines of the international trading system, and to seek further reductions of non-tariff and tariff barriers (to do this, we must reappraise the successes or failures and reasons for such results of the Tokyo Round Codes and the GATT itself, and review issues such as Most Favored Nation Treatment, permissive customs unions and free trade areas, safeguards, dispute settlement, and government intervention in trade); (2) to examine GATT machinery and the role of its Secretariat in order to improve its performance; (3) to help GATT adapt to the emerging needs of services, investment and intellectual property rights issues; (4) to review the linkages between trade and monetary matters; (5) to assist developing countries assume a more active and responsible role within the world trading system; (6) to secure maximum public support in order to improve present trading rules and institutions and to provide directions for solutions to other new or yet to emerge problems; and, (7) to seek renewed Presidential negotiation authority from the U.S. Congress.

Assuming that these multilateral negotiations do not conclude for a number of years, it is critical that any trade problems that arise in the interim be resolved through bilateral, GATT Plus, or plurilateral mechanisms, and be consistent with the U.S. objectives of the multilateral round.

In light of this, the Chamber believes it would be premature for it to take positions on specific issues or comment on detailed solutions until more preparatory work is done. The Chamber will become involved in this preparatory effort.

Chamber of Commerce of the United States of America

Washington

Statement on U.S-Japan Trade Relations

The dramatic increase in the bilateral trade deficit with Japan from $19 billion to $37 billion in two short years, the continuing need for reduction of trade barriers, and highly volatile exchange rate movements are causing a crisis in the domestic political arena. Such events could result in the Congress taking ill-conceived actions that might appear to alleviate the trade balance problem, but which could actually result in exacerbating the situation.

It is vitally important that our policy makers in Congress and the Administration carefully define the trade problems to be solved. Both nations need to share leadership and responsibility for maintaining and expanding a global trading system which is truly open.

Given the critical nature of the situation, the Chamber reviewed pending legislation and Administration proposals, and made the following policy recommendations:

1. The Chamber opposes legislation that mandates the President to take retaliatory action against any country, since the Chief Executive must retain the flexibility he has under existing law which permits him to initiate specific actions based on his perspective of the national interest.

   We oppose such legislation for the following reasons: The potential of such a law not being in compliance with existing international obligations; the irrelevance of such broad retaliatory action based on response to an industry specific action; and the fact that such retaliatory action will not gain better access to Japanese markets. The Chamber continues to support current trade law which is designed to counter unfair trade practices that inhibit market access to U.S. exports.

2. The Administration should push the Japanese harder on market access through the traditional mechanisms of bilateral negotiations and agreements, and General Agreement on Tariffs and Trade (GATT) procedures, including Article XXIII, "Nullification or Impairment", on a case-by-case basis. The objective of the Administration should be to develop a more coherent trade policy with Japan in order to significantly increase efforts to gain access for U.S. investment, products, and services.

3. In the event that these traditional mechanisms do not accomplish access for U.S. investment, products, and services within a reasonable period of time, the U.S. should utilize its rights under domestic and international trade laws, and reconsider such unilateral actions as may be appropriate, and consider major changes in existing domestic and international arrangements governing trade.

Attachment

Statement on Access to Worldwide Telecommunications Markets

The U.S. Chamber supports an active program of U.S. government bilateral and multilateral negotiations to remove foreign barriers to U.S. exports. The critical role played by telecommunications in international trade of high technology products and services gives a special urgency to efforts to address specific barriers to international trade in telecommunications products and value added telecommunications services. Therefore, the U.S. Chamber welcomes legislative initiatives to encourage the Administration to negotiate greater access for U.S. firms to worldwide telecommunications markets, provided that such legislation conforms to the following principles:

1. The aim of U.S. initiated negotiations should be to achieve open trade in telecommunications products and services.

2. Legislation should provide a mandate to the Administration to negotiate the reduction or elimination of barriers to telecommunications trade and should include the authority to negotiate the elimination of any remaining U.S. barriers.

3. Progress towards greater access should be determined by monitoring the results of existing and future trade agreements to assure that all barriers are removed.

4. The U.S. government should take flexible and credible action to enforce existing agreements and to restore competitive opportunities if negotiations fail to produce significant progress towards a more open market.

5. Any bilateral agreements entered into by the U.S. government should be supportive of future multilateral negotiations and the international trade and investment system.

6. Legislation to the extent possible should encourage the use of existing U.S. government trade authority.

Major International Trade Actions:
Reagan Administration
1/1/81-8/23/84

FREE TRADE

1. 4/14/81
President approves ITC recommendation to increase peanut quota by 300,000 pounds during the period of August 1980-July 31, 1981

2. 6/30/81
President removes OMA's on shoes from Korea and Taiwan.

3. 7/8/81
Administration issues statement on "U.S. Trade Policy."

4. 3/8/82
Department of Commerce finds no subsidies on Canadian lumber.

5. 4/9/82
President rejects quotas on casein imports.

6. 10/8/82
President signs Export Trading Company Bill.

7. 4/26/83
President rejects Houdaille petition, (Machine Tools).

8. 8/5/83
President signs Caribbean Basin Initiative

9. 9/15/83
Administration increases sugar quota by 150,000 short tons for FY'84.

10. 11/30/83
Administration signs law increasing share of U.S. funding to the IMF.

PROTECTIONIST

1. 4/1/81
Japanese initiated Voluntary Restrain Agreement on automobiles with U.S.

2. 9/11/81
Administration levied a 1 cent a pound import fee on imported raw sugar.

3. 12/22/81
Renewal of Multifiber Agreement. U.S. pushed for restrictive section. Restrictive textile bilaterals were agreed to through 1984.

4. 12/22/81
Farm Act of 1981 approved by Administration (wheat, corn, rice, sugar, peanuts, dairy, meat).

5. 10/20/82
Administration announces 3-year, $1.5 billion agricultural export credit program that will benefit from subsidized interest rates.
President approves ITC recommendation to increase peanut quota by 300,000 pounds during the period of August 1980-July 31,1981.

6. 10/4/82
President promised import regime on textiles which would "relate" imports to growth in domestic consuption.

7. 10/21/82
U.S.-E.C. Steel Agreements to restrain imports of EC steel into the U.S.

11. 8/6/84
Administration rejects ITC recommendation to impose quotas (425,000 tons) or raise tariffs (by .05 cents per pound) on imported copper because restrictions were "not in the overall national economic interest."

12. 8/18/84
Administration rejects ITC recommendation to impose quotas on steel imports and a terriff quota on semi-finished steel.

Compiled by:
Consumers for World Trade/Washington, D.C.

8. 1/15/83
Administration imposed a unilateral ceiling (700 million level reached in 1982) on imports of Chinese textiles.

9. 1/18/83
(Egypt)
Administration subsidizes wheat flour sales to Egypt, Morocco and Iraq in retaliation to subsidized EC sales of wheat and flour.

10. 4/1/83
President approves 45% increased duties on imported motorcycles.

11. 5/10/83
President reduces quotas on sugar from Nicaragua by 90%. Action taken in retaliation for Nicaragua's support of guerilla activities in Central America.

12. 7/5/83
President imposes tariffs and quotas on a wide range of specialty steel products for 4 years.

13 12/16/83
President agreed to tighten restrictions on textile imports. The restrictions addressed themselves to "low-waged third market nations.

14. 8/3/84
Administration announces new "country-of-origin" provisions on textile imports.

15. 8/18/84
Administration calls for negotiated cutback of steel imports to 18.5% of the American market.

Chairman LAFALCE. Shortly we will go to questions, but first we have Mr. William R. Cline, senior fellow with the Institute for International Economics. This is Mr. Cline's umteenth appearance before the Banking Committee, and also on many occasions before this subcommittee. But when someone has so much knowledge and presents it so well, we like to reap the benefit of that knowledge and expertise.

Mr. Cline.

STATEMENT OF WILLIAM R. CLINE, SENIOR FELLOW, INSTITUTE FOR INTERNATIONAL ECONOMICS

Mr. CLINE. Thank you very much, Mr. Chairman.

In the interest of time, I will very sharply condense my comments from the first half of my testimony and then turn my attention to the second half, which is really the emerging problem and what we should do about it.

The thrust of my testimony is, first of all, that there is intense pressure for protection, perhaps the worst since the 1930's; second, that its cause is the overvalued dollar; and third, that the key action to remedy the problem is to cut the fiscal deficit.

The rise in protectionism really began in the mid-seventies. In 1977, we put quotas on footwear and television sets. Despite the Reagan administration's commitment to the principle of free trade, in 1981 the new administration induced voluntary quotas on automobiles from Japan. In 1982, it imposed sugar quotas. In 1982, it essentially established a cartel-like arrangement of quotas on steel from the European Community, which was extended in 1984 to the rest of the world.

In 1981, the new administration participated in the tightening of the multifibers arrangement, which protects textiles and apparel, and further tightened the mechanism through administrative changes in 1983 and 1984.

There were some liberalizing moves, as well. In 1981, we allowed the television and footwear restrictions to lapse, but these were small in comparison with the major drift towards protectionism.

The most important liberalization decision was the one this March in which the administration decided to allow the quotas on autos from Japan to expire. The Japanese felt that they could not get away with totally free trade in automobiles, and so they retained some restrictions.

One estimate would suggest that auto imports, even after the liberalization, will be about 300,000 less per year than they would be with no limits at all. And I think the congressional reaction, the extreme frustration with even the increase that was announced, the 24-percent increase, is evidence that the Japanese were facing reality that whatever the White House said, they faced such a backlash that they really couldn't from one day to the next completely liberalize automobiles.

The consequence of this trend has been that in the last few years, fully one-third of the U.S. market for manufactures has been substantially protected by nontariff barriers. I have a table on page 6 of my prepared testimony which gives a summary of these measures, and in particular of their costs.

Protection is extremely costly, especially to the consumer, but also to the nation at large. On page 6, you will see that the total of annual costs of this protection is something like $18 billion; and the cost per job saved can be staggering, from $160,000 per job saved, or created—however you want to look at it—in automobiles, according to estimates by Crandall, or as low as $40,000 per job saved or created in textiles and apparel, according to studies by the Federal Trade Commission. These are all extremely high figures, even the lowest of them.

I submit it would be cheaper for the American consumer to simply retire the affected workers, whose jobs are saved or created by protection, at full salary and send the bill to the consumers. They would experience a large savings.

So, first, protection is very substantial in this country, has been; and second, it is very costly.

Now, despite that fact, the pressure for protection has been increasing, and what we look at today is a prospect of sharply higher protection rather than a rollback of existing protection. We have heard about the proposal on textiles and apparel. That proposal, in practice, would cut imports of textiles and apparel by something like 15 percent, from Hong Kong and Japan, 40 percent from Korea and Taiwan, 60 percent from China.

The Reagan administration Cabinet officials have stated that the cost of this bill would be $14 billion a year to the American consumer. Others estimate as high as $23 billion.

I would like to single out one thing in that bill. Its preamble says essentially this sector has 50-percent import penetration. Well, one has to be careful with these figures. Even on the physical measures—square yards, et cetera—my reading of the Commerce Department figures is a little different; it comes somewhere in the range of 30-percent import penetration. It may be the bill is referring to the ratio of imports to production rather than imports to total consumption.

But the more important difference is to look at the value relationships. In footwear, as in apparel, a lot of the imports are concentrated in low-value units, so it is adding apples and oranges to compare the imports directly in square yards to the domestic production.

When you look at it in value terms, the import penetration of our market in textiles and apparel is more in the range of 20 to 25 percent rather than 50 percent. And that is a very important factor to keep in mind in judging the seriousness of the situation.

We have also got the risk of new protection in footwear. The International Trade Commission has recommended an 18-percent cutback in imports of footwear valued over $2.50 per pair. According to press reports of some of the ITC's staff estimates, protection of this nature could cost the American consumers well over a billion dollars. My own estimates would suggest that the costs could be closer to the range of $2.5 billion. Now, these costs would again mean a consumer cost per job saved in the range of $50,000 to $80,000.

Now, in addition to the sectorial pressures, we see a broad pressure across the board. First of all, we are edging towards a trade war with Europe and with Japan, a two-front trade war. We have already started the pasta war which the Reagan administration has imposed.

Chairman LaFalce. Mr. Morsani, listen to these remarks closely now.

Mr. Cline. I recognize the Italian-American concern about this. The pasta war has begun with a 25- to 40-percent tariff on pasta. We can expect counter retaliation soon from the European Community.

In the case of Japan, we have heard about the bilateral trade deficit that could reach $50 billion by this year. There is extreme pressure. We have heard about the unanimous concurrent resolutions and their various offshoots that call for retaliation if the Japanese do not open their markets.

Now, we have made some progress in negotiations with the Japanese. U.S. negotiators in recent months have achieved commitments to more transparent technical standards in telecommunications, pharmaceuticals and medical equipment, to the protection of copyright in computer software.

In addition, Prime Minister Nakasone has pledged a substantial market opening package by July of this year. The fact is that Congress and a lot of businessmen tend automatically to be skeptical of these Japanese commitments, and there remains intense pressure for retaliatory reciprocity bills.

Going beyond sectors, going beyond just Europe and Japan, we come to the range of protectionist requests for an across-the-board surcharge, a 20-percent surcharge. Now, this is justified on the grounds that not only would it give import relief, but it would also raise revenue and address our fiscal deficit.

Well, I must say that economists always tell their students that it is only the poor countries, the least developed countries, the "banana republics," that have to use tariffs to raise revenue, fiscal revenue. It is a sign of backwardness, it is a sign of inefficiency, and it is recognized as inefficient for the economy and only to be resorted to if it is impossible to take responsible fiscal action. I hope that is not where we are.

One also has to remember that if we impose a surcharge, one would have to expect retaliatory action from abroad. The dollar is the single most important cause of the pressure for protection, and the large U.S. trade deficit. The real value of the dollar has risen since 1980 anywhere between 40 and 70 percent, perhaps even higher, depending on the particular index that you choose.

My colleague at the Institute, John Williamson, calculates that the dollar is about 40 percent overvalued compared to a value that would be sustainable on a longterm equilibrium basis in which we might be having plausible sustainable amounts of capital inflow, somewhere in the range of $10 billion a year, instead of obviously unsustainable flows of the $100 billions or so that we are currently absorbing. Forty-percent overvaluation is a 40-percent tax on exports and a 40-percent subsidy to all imports. Under those circumstances, it is no surprise that protectionist pressures are rising.

Now, the cause of the overvalued dollar, I would submit, is primarily the large fiscal deficit. The large fiscal deficit puts a strain on credit markets. Combined with a monetary policy that refuses simply to print money to monetize the Federal deficit, the consequence is a rise in the interest rate. The rise in the interest rate causes foreigners to try to put their money in this country to earn the high interest rate and causes Americans to bring their money home. We have had a drying up of U.S. money moving abroad. It has turned around and come home. Those actions both bid up the price of the dollar. The dollar rises, and that is where we are.

Now the consequence of this is soaring imports. In 1984, U.S. nonoil imports rose by 31 percent. If you look at table 2, page 16 of my testimony, you will see that in this surging tide, there were a lot of sectors that went right along with the tide. Footwear was up 25 percent. Well, that is nothing special, considering everything else is up 31 percent. But it was pulled along. Textiles and apparel, those were up 40 percent. Again, the bulk of that accounted for just the general surge in imports.

Now, obviously, when there is a huge surge of imports across the board like this, it is the sectors already most exposed, already most vulnerable that are going to get hit the hardest. Now, as Mr. Morsani has pointed out, this surge in imports hasn't just been with one or two culprits who we might accuse according to some people of unfair trade. He pointed out that Canada has a $20 billion surplus with us. One could also cite Taiwan at $11 billion, both Mexico and Brazil at $6 billion. It is an across-the-board thing.

Let's think a little bit about the long-term implication of this strong dollar. The dollar is one of the single most important prices in the economy. And it is a signal of where the economy should put its resources. What the strong dollar is doing is signaling that resources should go to the production of nontradable goods: haircuts, housing, subways, and that resources should come out of tradable goods: automobiles, steel, computers, agriculture. It is beginning to show up very painfully in the composition of this recovery.

In past typical recoveries, industry keeps pace with the general GNP. This year—this time around, from 1979 to 1984, GNP rose by 11 percent, manufacturing rose by only 7.5 percent. The lag is showing up. And it would be much worse if we hadn't had an explosion in defense spending.

Now, we didn't have an explosion in Government spending for agriculture, and there it is really showing up. Agricultural output has declined by 2 percent in that period, where by past relationships it would have risen by 7 to 8 percent. We have near depression conditions in agriculture, and the dollar and the distortion to where we put our resources, tradable goods, versus nontradable goods is the cause.

Now, the policy measures seem to me to be very clear. We have to address the trade problem at its origin, not at the level of its symptoms. The large fiscal deficit has to be cut. With a lower fiscal deficit, there will be less strain on the credit markets, a lower interest rate, and a decline in the dollar.

That will make the U.S. producers more able to compete not only with imports but also in the international market for exports. The longer Congress and the administration delay cutting the fiscal deficit, the more they raise a risk of an outbreak of severe protection.

Some of our institutional mechanisms may already be generating protection that is inappropriate over the longer term. The ITC mechanism has no clause that says protection shall not be granted if the cause is a temporary misalignment of the exchange rate. That concept doesn't exist in this legislation, in this mechanism. So what we could wind up with is a number of industries that get an injury determination, that get protection, and 2 years from now when the dollar hopefully is very significantly down, those industries could be still protected and become entrenched in that protection.

In addition to action on the deficit, it seems to me there is a second track of policy, which is action on trade negotiations. It seems to me that it is essential to move ahead with multilateral negotiations. Some progress has been made in bilateral negotiations with Japan, but multilateral negotiations, a new round, would help a good deal because it would then be more possible to tell industries who will have complaints that we are negotiating about it in the context of an ongoing process.

Now, Congressional leaders are right to impress on the administration that the dollar has to be corrected as part of this process. But I think it would be wrong to choose the route of inaction on the Federal deficit and roadblock to multilateral trade negotiations until the dollar came down. That would be an irresponsible strategy. Instead it seems to me there has got to be prompt action on the deficit, No. 1, and, No. 2, that should be accompanied with prompt movements toward multilateral trade negotiations.

Thank you, Mr. Chairman.

Chairman LaFalce. Thank you very much, Mr. Cline, for your excellent presentation.

[Mr. Cline's prepared statement, "Pressures for Import Protection and U.S. Policy," follows:]

PRESSURES FOR IMPORT PROTECTION AND US POLICY

Statement by

William R. Cline, Senior Fellow
Institute for International Economics

before the

Committee on Banking, Finance, and Urban Affairs
Subcommittee on Economic Stabilization
US House of Representatives

June 26, 1985

The pressures for import protection are perhaps more intense today than at any time since the 1930s. The overvalued dollar is responsible for much of this pressure. In the last two years protection has increased in several important industries. If corrective measures are not taken to return the dollar to a long-term equilibrium level, the current threat of widespread new protection could become a reality. New protection would impose heavy costs on consumers and might cause retaliatory protection abroad, leading to a general protectionist spiral like the one that contributed to the Great Depression in the 1930s.

Rising Protection

US markets were probably at their most open level in the mid-1970s, when concern about high inflation led to the dismantling of several major non-tariff barriers. By the late 1970s protection was on the rise again, with the introduction of voluntary export quotas and orderly marketing agreements on color television sets and footwear, a "trigger-price" mechanism that discouraged imports in steel, and tightening of the Multi-Fibers Aggrangement (MFA) covering textiles and apparel.

The Reagan administration has repeatedly stated its commitment to the principle of free trade. Yet, in the face of pressure generated by unemployment and by the overvalued dollar, the administration has been responsible for several major protectionist acts. In 1981 the administration succumbed to pressure for automobile protection and induced a voluntary quota of 1.68 million units annually on Japanese automobiles. Through the 1981 renewal of the MFA the administration tightened protection on textiles and apparel, and it adopted administrative procedures in December, 1983 and August, 1984 that further restricted imports.1/ In 1982, the government adopted quotas on sugar imports, and negotiated a cartel-like regime of voluntary quotas on steel imports from the EC. In 1984, the administration extended the steel quota regime to cover other suppliers in addition to the EC, with an overall limit for steel imports set at a target of 20.5 percent of the US market (18.5 percent excluding semi-finished steel).

There has been some liberalization as well, but not enough to counter the trend toward more severe protection. The Reagan

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1. The 1981 MFA effectively ended the Arrangement's previous commitment to 6 percent annual growth in quotas. The December 1983 decision made calls for bilateral negotiations more automatic in response to triggers based on import penetration, and the August 1984 decision tightened rules of origin on apparel from one country made from materials from another.

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administration did allow television and footwear quotas to lapse in 1981, but these product sectors are far smaller than those that received new protection. The most important case of liberalization was the President's decision in March of this year to allow the voluntary quotas on Japanese automobiles to expire. However, the Japanese government feared a backlash if it freed exports entirely, and limited the next year's exports to 2.3 million units. Japanese fears proved warranted, because the 24 percent increase so enraged many members of Congress that a new outbreak of anti-Japan protection has threatened in subsequent months. The end result is that automobiles remain protected, with prospective imports still perhaps 300,000 units lower than would occur without the quotas.[2]

Costs of Protection

Altogether, approximately one-third of the US market for manufactures has been protected by non-tariff barriers in recent years.[3] This extent of protection is serious, considering the costs of protection. Consumers bear the bulk of these costs in the form of higher prices, not only for imports but also for the domestic products that no longer face as much competition from abroad. Even after taking account of the gains to domestic

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2. According to estimates by US Trade Representative William Brock in early 1985. Wall Street Journal, February 21, 1985.

3. William R. Cline, Exports of Manufactures from Developing Countries (Washington: Brookings Institution, 1984), p. 60. A narrow measure excluding automobiles, footwear, and television sets still shows 19 percent of the market as protected. Both measures are based on consumption weights.

producers from higher prices and sales volume, the economy as a whole is worse off under protection. The economy allocates resources to inefficient production, causing a production efficiency loss; and there are net consumer losses that are uncompensated by transfers to producers.

Robert Crandall has estimated that automobile quotas in 1981-83 raised the prices of Japanese cars in the US market by $920 to $960 per car and the price of domestic automobiles by $370 per car, for a total cost to consumers of $4.3 billion annually. The corresponding cost per job created was $160,000 per job.[4]

Tarr and Morkre of the Federal Trade Commission have estimated that the costs to steel consumers from the 1984 extension of steel quotas amount to $1.13 billion annually, or $113,622 per job created.[5] The authors estimate the net costs of inefficiency to the economy as a whole at $803 million annually. Moreover, this calculation does not include the costs of prior protection under the quota regime negotiated with the EC, nor of the self-restraint on steel exports that had already been maintained by Japan since 1978.[6] The FTC analysts estimate

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4. Robert W. Crandall, "Import Quotas and the Automobile Industry: the Costs of Protectionism," The Brookings Review, Summer, 1984.

5. David G. Tarr and Morris E. Morkre, Aggregate Costs to the United States of Tariffs and Quotas on Imports: General Tariff Cuts and Removal of Quotas on Automobiles, Steel, Sugar, and Textiles (Washington: Federal Trade Commission, December 1984), p. V1-7.

6. Ingo Walter, "Structural Adjustment and Trade Policy in the International Steel Industry," in William R. Cline, ed.,

the consumer costs of sugar quotas at $735 million annually. In apparel, they find that quotas on clothing products from Hong Kong cost US consumers $384 million annually and cause an inefficiency cost to the whole US economy of $372 million annually--or $41,800 per job created.[7] Considering that the apparel products examined by the authors accounted for only 13.7 percent of total US imports of apparel in the base year (1980),[8] total US consumer costs from quotas on apparel would appear to be in the range of $2.6 billion annually. In addition, high tariffs on textiles and apparel have been estimated to cost US consumers as much as $9 billion annually.[9]

Table 1 recapitulates the consumer costs of the major cases of protection reviewed here. In summary, not only has protection by major non-tariff barriers been extensive, covering approximately one-third of the US market for manufactures in recent years. In addition, protection is costly to consumers, and can be highly inefficient in its goal of creating domestic employment. Consumer costs from protection have been well over $100,000 per job created in autos and steel and over $40,000 in apparel. At this price, the consumer would be better served if

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7. Tarr and Morkre, Aggregate Costs, pp. 19; IV-25.

8. Ibid. and OECD, Trade by Commodities: Market Summaries; Imports, Schedule C, Jan.-Dec. 1980.

9. Martin Wolf, "Textile Pact: The Outlook," New York Times, January 12, 1982.

Table 1
Consumer Costs of Protection in Selected Sectors

Sector	Study	Annual Consumer Costs of Protection [a] ($ million)	Consumer Cost per job created ($)
Automobiles	Crandall	4,300	160,000
Steel[b]	Tarr-Morkre	1,130	113,622
Apparel			
quotas, Hong Kong	Tarr-Morkre [c]	384	41,800
quotas, total		2,800	41,800
Textiles-apparel tariffs	Wolf	9,000	n.a.
Sugar	Tarr-Morkre	735	n.a.

a. Except textiles-apparel, refers to quotas and voluntary quotas only.
b. Refers only to the increase in protection from extension of voluntary quotas in 1984.
c. Derived from Tarr-Morkre.

Source: See text.

the government retired the workers involved at full salary and sent the bill to the consumers.

Rising Pressures for Protection

Despite the high cost of existing protection, there are intense pressures for adding still more import restrictions. One pending bill that has already marshalled substantial support in both houses of Congress would roll back imports of textiles and apparel to 1980 levels plus an allowance for 6 percent growth since then, and in addition hold down future import growth from major suppliers to 1 percent annually.[10] In practice these restrictions would cut back textile-apparel imports by as much as 30 percent, with reductions ranging from 15 percent for Hong Kong and Japan to 40 percent for Korea and Taiwan and 60 percent for China.[11] Cabinet officials of the Reagan administration have just recently issued a statement opposing this proposal, which the administration estimates would cost US consumers $14 billion annually.[12]

In the preface to this bill, its authors emphasize that import penetration in apparel products reached 50 percent in 1984.[13] However, the Department of Commerce reports that for

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10. S.680 and H.1562.

11. Consumers for World Trade Newsletter, May-June 1985; Journal of Commerce, June 3, 1985.

12. Journal of Commerce, June 25, 1985. Note that the Retail Industry Trade Action Coalition has estimated the bill's annual consumer costs at $23 billion. London Financial Times, June 20, 1985.

most recent year with data available, 1983, the ratio of the physical volume of textile and apparel imports to domestic consumption was only 30.2 percent for cotton products, 36.1 percent for wool products, and 11.2 percent for products from man-made fibers.[14] Moreover, because imports tend to be concentrated in lower-value products, a more meaningful measure in economic terms for import penetration is the ratio of import value to the value of domestic consumption, not the corresponding ratio in physical terms (such as square yards). According to the American Textile Manufacturers Institute, total shipments of textile and apparel products from US plants amounted to $52.17 billion in 1983 and approximately $56 billion in 1984.[15] In comparison, total imports of textile and apparel products ammounted to $12.8 billion in 1983 and $18.0 billion in 1984 (table 2 below). Exports of textiles and apparel were $3.2 billion in 1983 and again in 1984. Accordingly, on a value basis, the ratio of imports to domestic consumption of textiles and apparel was 20.7 percent in 1983 and 25.4 percent in 1984--far below the import penetration of 50 percent implied by the bill's preamble.[16]

New protection also threatens in footwear. The

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13. S.608, p. 3.

14. US Department of Commerce, Import/Production Ratios for Cotton, Wool, and Man-Made Fiber Textiles and Apparel (Washington: March, 1985), p. 3.

15. American Textile Manufacturers Institute, Inc., Textile Hi-Lights, December 1984, p. 12.

16. Domestic Consumption = production + imports - exports.

International Trade Commission has recommended that imports of non-rubber footwear, excluding pairs valued at import value of less than $2.50, be cut back to 474 million pairs per year, a reduction of approximately 18 percent from the 1984 level.[17] Staff estimations of the ITC indicate that the consumer costs of such protection would reach $1.3 billion annually. My own rough estimates would suggest that consumer costs could reach as high as $2.5 billion annually. The corresponding consumer cost per job created would range from $50,000 to over $80,000.[18]

More generally, the United States today may be edging toward a two-front trade war. Tensions are mounting again over US imports of steel from the EC on products not covered in the 1982 quota agreement.[19] And the opening shots have already been fired in a "Pasta War," as the Reagan administration has announced new tariffs of 25 to 40 percent on European pasta (mainly from Italy) in retaliation for EC discrimination against US citrus products.[20] EC counter-retaliation in related agricultural products may be expected.

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17. US International Trade Commission News, June 17, 1985.

18. Washington Post, June 14, 1985. In an earlier study I estimated that a 20 percent rollback in all footwear imports, from a 1982 base, would cost consumers $2 billion annually. Given the rise in average price and import volume, on the one hand, and the exclusion of 150 million pairs of footwear under $2.50 per pair, on the other, an approximate revised estimate of consumer cost would be $2.5 billion annually. William R. Cline, Footwear Imports and the Consumer (Washington D.C.: International Economic Analysis, Inc., 1984), p. 62.

19. New York Times, May 15, 1985.

20. Wall Street Journal, June 21, 1985.

Nor is all quiet on the Western front. As the US bilateral deficit with Japan has soared to $37 billion in 1984 and, many expect, as high as $50 billion this year, protectionist pressure against Japan has surged as well. A rare, unanimous Senate concurrent resolution earlier this year urged the President to demand that, within 45 days, Japan liberalize its markets by enough to offset the expected rise in US auto imports from Japan, or else face US retaliation that would cut imports from Japan by this amount.[21]

In recent months US negotiators have obtained a Japanese commitment to simplify and make more transparent technical standards in telecommunications, pharmaceuticals and medical equipment, and to protect computer software copyrights; and in addition Japan's Prime Minister Nakasone has pledged a market opening package by July of this year. But Congressional skepticism runs deep, and the list of proposed legislation includes bills to impose a surcharge on all imports from Japan, as well as "reciprocity" bills calling for retaliation in telecommunications, semiconductors, and other sectors.

Not only is the protectionist tide reaching traditionally sensitive sectors and heightening tensions with Japan and the EC. In addition, it has led to calls for broad protection on all products. In particular, the notion of a 20 percent surcharge on all imports has gained increasing attention in recent months. Some advocates argue that an across-the-board import surcharge would help reduce the fiscal deficit and compensate for dollar overvaluation. But it would be a devastating commentary indeed if the United States found it necessary to join the ranks of the poorest, least developed countries that still find it necessary to use import tariffs as their source of tax revenue despite the well-known adverse effects of tariffs. Moreover, an across-the-board surcharge would have a severe impact on major debtor nations and the stability of US banks, and would be likely to evoke retaliation from the major trading powers.

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[21] Congressional Record, March 28, 1985, p. S3573.

Role of the Dollar

The single proximate cause of the rise in protectionism is the overvaluation of the dollar. Adjusting for inflation at home and abroad, the real value of the dollar relative to other currencies has risen by 40 to 70 percent, depending on the particular index chosen for measurement. My colleague John Williamson has calculated that as of the fourth quarter of 1984, the real value of the dollar in terms of other major currencies was 37 percent above the level that is compatible with long-term equilibrium.[22] Overvaluation by approximately 40 percent has the same effect as a 40 percent tax on exports and a 40 percent subsidy to imports. Under those circumstances a wide range of products experience pressure, and it is no surprise that rising protectionism is one result.

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[22] Over the longer term the United States might sustain a capital inflow of perhaps $10 billion annually, in contrast to the current rate of approximately $100 billion annually. The dollar would correspondingly have to decline to stimulate exports and reduce imports. John Williamson, The Exchange Rate System (Washington: Institute for International Economics, POLICY ANALYSES IN INTERNATIONAL ECONOMICS NO. 5, Revised edition, June 1985), p. 82.

The root cause of dollar overvaluation is the large fiscal deficit. Combined with a relatively tight monetary policy that refuses monetization, the large deficit drives up US interest rates. High US interest rates attract capital from foreigners and cause US investors to place their capital at home instead of abroad. The resulting demand for dollars in the exchange market drives up the price of the dollar.

The results of a rising dollar have been devastating for US trade. As shown in table 2, US imports soared in 1984 by 26 percent. As exports faltered under the burden of an overpriced dollar, the trade deficit reached an unprecedented level of $123 billion. The bilateral deficit of $37 with Japan was only one manifestation of this dynamic; the bilateral deficits rose sharply for trade with other countries as well (including a $20 billion deficit with Canada, $9 billion with Germany, $11 billion with Taiwan, and $6 billion with both Mexico and Brazil).[23/]

The exchange rate is one of the most important prices in the economy. An overvalued dollar gives an incorrect signal to the economy to reallocate resources away from tradable goods (exports and import-substitutes), towards production of non-tradable goods and services (housing, subways, and so forth). As a result, tradable goods have been sharply discriminated against. Agriculture is in a state of near-depression because of the

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23. Department of Commerce, Highlights of US Export and Import Trade, December 1984.

dollar's effective tax on exports. And despite the stimulus of defense spending, manufacturing has lagged behind its normal cyclical response to the recovery.[24/]

In this environment it is no wonder that generalized protectionism is on the increase. Moreover, it is understandable that the sectors that have been traditionally the most vulnerable to imports have been the first to be affected. As table 2 shows, imports rose by 40 percent in textiles and apparel in 1984, after rising approximately 15 percent in 1983. The 60 percent rise in steel imports was overstated by the sharp contraction of the export base in 1982-83 but nonetheless reflected growing pressure from the exchange rate. As for footwear, the increase in imports in 1984 was somewhat smaller than that of non-oil imports overall, but imports had already reached a high base.

Policy Measures

The trade problem must be addressed at its origins, not at the level of symptoms. The large US fiscal deficit must be cut. With a lower fiscal deficit there will be less strain on credit markets, a lower interest rate, and a decline in the dollar. As the dollar declines, the ability of US producers to compete with foreigners will increase, both in competition against imports in the domestic market and in the sale of exports abroad. The longer Congress and the administration delay reductions in the fiscal deficit, the more they raise the risk of

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24. William R. Cline, "Changing Stresses on the International Economy," World Economy, forthcoming.

an outbreak of severe protectionism in an attempt out of frustration to deal with the symptoms of the economic imbalance instead of its causes.

Some of our institutional mechanisms could in fact generate this protection very soon. There is no provision in the mandate of the International Trade Commission to adjust for the exchange rate when determining whether import injury is present. As a result, a number of industries might be granted protection, through the ITC safeguard mechanism, that could suddenly become inappropriate within a year or two if the dollar declined substantially. In reaching final decisions on the ITC recommendations, the President should take this factor into account.

As for Congressional actions more directly on protectionist legislation, the proper course for policy is clear. It is essential to act quickly in reducing the fiscal deficit. The alternative of imposing new protection would introduce new inefficiencies and consumer costs that could become entrenched over time regardless of the future course of the dollar. In addition, the adoption of wide-ranging protectionist legislation would be likely to set off a dangerous spiral of international retaliation.

If deficit reduction is the first crucial track for dealing with the problem of trade, a second and parallel track is the development of trade negotiations. US negotiators are to be commended for recent progress in talks with Japan. It is time, however, for a broader approach. It is now time to launch a new round of multilateral trade negotiations. With such negotiations in progress, it would be easier to address sectoral problems through negotiation instead of unilateral protection.

Congressional leaders are right to impress on the administration that correction of the overvalued dollar must go hand in hand with a new round of trade negotiations. But the proper implementation of this objective requires prompt action to reduce the fiscal deficit and to begin trade negotiations. The alternative of inaction on the deficit, accompanied by a roadblock to trade negotiations until such time as the dollar declines, would not be a responsible approach.

Table 2.

US Imports of Selected Products, 1981-84

	Amounts				Percent change		
	1981	1982	1983	1984	1982	1983	1984
I. Values ($ billion)							
Total	273.35	254.88	269.88	341.18	-6.8	5.9	26.4
Oil	79.70	62.66	55.27	59.21	-21.4	-11.8	7.1
Non-oil	193.65	192.22	214.61	281.97	-0.7	11.6	31.4
Textile fabric, yarn	3.05	2.81	3.22	4.53	-7.9	14.6	40.7
Clothing	7.54	8.16	9.58	13.50	8.2	17.4	40.9
Footwear	3.02	3.44	4.01	5.03	13.9	16.6	25.4
Iron and steel	11.21	9.61	6.34	10.21	-14.3	-34.0	61.0
Sugar	2.14	0.86	1.05	1.26	-59.8	22.1	20.0
Passenger cars	17.54	19.76	22.93	29.21	12.7	16.0	27.4
II Physical Quantities							
Footwear a/	648	717	855	1,002	10.6	19.2	17.2
Iron and steel b/	19.8	16.8	16.8	26.0	-15.2	0.0	54.8
Sugar b/	5.05	2.84	2.98	3.45	-43.8	4.9	15.8
Passenger cars c/	2.82	2.84	3.05	3.55	0.7	7.4	16.4
III. Memorandum:							
Real dollar exchange rate Index as % of 1976-77 equilibrium level	110.7	122.2	126.0	135.5	10.4	3.1	7.5

a. Million pairs.
b. Million tons.
c. Million units.

Source: International Financial Statistics, May 1985; Commerce Department, Highlights of US Export and Import Trade, December 1982 and December 1984; and John Williamson, The Exchange Rate System, (Washington: Institute for International Economics, Revised edition, June 1985.

Chairman LaFalce. We really are honored that Congressman Gibbons has seen fit to attend the entire hearing thus far. Sam, if you would like to participate with us or make any comment now, whatever your pleasure.

Mr. Gibbons. I am here to listen. I must say I agree strongly with Mr. Cline's very detailed analysis of what the problem is.

Chairman LaFalce. Thank you very much.

Ms. Stern, I have introduced a bill, H.R. 1808, which would require the convening of an industry adjustment board as part of the section 201 process, and would authorize the ITC to recommend a broader range of remedies where imports are found to be an important, but not primary, cause of injury.

What are your thoughts of such a proposal? What, if any, changes do you believe are necessary in the section 201 provisions to enable the ITC to better handle the problems of industry adjustment?

Ms. Stern. Speaking for myself, there are two elements you asked me about, one is the board, and the other is giving relief under section 201.

Chairman LaFalce. I asked about it because that is what I provided for in my bill.

Ms. Stern. I would like to talk about the second first, the question of laying out some sort of adjustment plans for an industry which may not rise to the level of import relief under section 201. In other words, imports may be found to be an important cause of injury, but not as important as any other cause. In fact, that is exactly how I analyzed the steel industry last year, the carbon steel industry. I found, looking at the different product lines, that there were other causes.

For example, decline in consumption in certain plate areas and sheet areas were a far more important cause of injury the industry was feeling than were imports. And there were other causes in some of the other product lines. I won't go into a whole analysis on the steel industry, but the point is that did not mean that imports were not an important cause. And it did not mean that this industry didn't have other problems which should be attended to.

I really believe that the idea that the industry is either a winner or loser, in other words, they either get import relief or nothing at all, leads to a situation—for example, in automobiles, when the Commission or the majority of the Commission found imports were not the most important cause of serious injury. It is not going to fly politically with many industries, and there will be efforts to get relief elsewhere, and sometimes they are fixated on import relief when there are other problems.

So I believe having the flexibility of having the Commission discuss other remedies beyond the limited remedies which are on the menu in the statute is very helpful. As you know, as it stands now, the menu includes quantitative restrictions, quotas, tariffs or adjustment assistance. Adjustment assistance is expiring in September, and even if it weren't expiring, the President has not funded it in any sufficient manner. So that has, in effect, been removed from the menu.

Tariffs, in effect, have been watered down by the effect of the exchange rate. When you have the dollar rising as fast as it has over the last couple of years, you give a tariff remedy to an industry, and it can be wiped out overnight when the dollar goes up. So you are left with qualitative restrictions or nothing at all.

As I said, in some of these industries import relief is not even merited. I believe the idea of giving more flexibility is a very good one.

Then you get into the question of how do you do it? That gets into your question about the board. The bifurcation that you have between considering serious injury and if the industry is not seriously injured, basically that is the end of the examination, is a good one. In fact, however, we already look at petitions before they actually come in formally. If we feel there is little merit, we will signal that industry, "You have to get a stronger case before you bring it." But the bifurcation is a good one, so once you start focusing on the whole adjustment plan, convening this board and focusing on this adjustment plan under title II of your statute, leads me to the question: Who is going to represent whom? What happens if the industry is not unionized? Who is going to come to the table for labor? What happens if the industry is made up of firms half of which are unionized and half which aren't? Who is going to come to the table?

Can the International Trade Commission represent the government? We are an independent agency, independent of the executive branch. How do we make those deals? Your provision does provide for a recommendation. It may not matter that much if we are simply recommending to the President. We think this is the best negotiated deal given the constitution of the membership. I dare say some of the biggest fights are going to be who is going to be at that table before you even discuss what the adjustment plan is.

So I do believe——

Chairman **LaFalce**. But that is always true, whenever you have negotiations. Sometimes negotiations with the Chinese or Koreans, whoever it may be, have been stalled over who will be at the table, whether it should be a rectangular or oval table. That is part of the dialog, and reconciliation doesn't mean you can't deal with it.

Ms. **Stern**. The reason I underline it is, it is a political question. And if it is political, should elected or nonelected officials be involved?

Chairman **LaFalce**. Let us pursue that. The 201 remedy is ultimately a matter of Presidential discretion and, therefore, sometimes it can prove futile even if a finding of jury and a recommendation is made. Sometimes there is a finding that suggests temporary relief, but conditioned—I think this is what you did with respect to the steel industry. I don't know that adequate conditions were imposed pursuant to the ITC suggestions.

Would it be reasonable for 201 determinations, like countervailing determinations, totally within the realm of the administering authority remove the element of Presidential discretion? Try to disassociate yourself from your present position as chairperson and look at it as you would look at it if you were retired from that position.

Ms. **Stern**. I think it raises the question of whether the Commission looks only at the condition of the industry, which is what we do now, or whether we should be looking at other considerations, which is what the President must do.

Chairman LAFALCE. Let's pursue that. Is it adequate for you to look just at the condition of the petitioning industry? You spoke knowledgeably and eloquently about the secondary but important effects on other industries. Do you need a legislative sanction to look at a wider impact than just on the petitioning industry?

Ms. STERN. Under the law now, we are not looking and do not take into account what the consumer cost is. We are there to protect the domestic industry and recommend to the President what remedy is——

Chairman LAFALCE. So your recommendations to the President do not take into consideration cost to the consumer.

Ms. STERN. Absolutely not. That is one of the considerations the President should take into account.

Chairman LAFALCE. But who gives the President that information?

Ms. STERN. OK. Now, this is something we have been increasingly called upon to do, an analysis. Last year we were asked on a more or less formal basis in a letter to provide to the President this kind of calculation, which we will provide to the President, but it is not——

Chairman LAFALCE. In one case or all cases?

Ms. STERN. In all of them.

Normally whenever an industry then gets the relief, we are also asked to do a review of the industries on a quarterly basis, what the production, what the different data are for the industry.

Chairman LAFALCE. Mr. Cline has suggested in a great many cases, if not all—you can correct me if I am mischaracterizing your statement—we would have been better off not giving any trade relief, the consumer would have wound up better off. That is primarily looking at it from a dollar and cents perspective as opposed to the need for having some viable industries.

First of all, Mr. Cline, have I fairly characterized your statement?

Mr. CLINE. Yes.

Chairman LAFALCE. Ms. Stern, would you care to comment on that opinion of Mr. Cline?

Ms. STERN. From the dollar and cents point, you wisely pointed out that the consideration there and the question is: What do you do with the industry?

Chairman LAFALCE. Which leads me to Mr. Morsani, too. Mr. Morsani was speaking of so much of the aggregate condition of the American industry in his comments, but it is one thing to look at the aggregate. But isn't it important, whether we have domestic steel industries, auto industries, machine tool industries, et cetera, rather than simply looking at aggregates? I will let Ms. Stern go first.

Ms. STERN. You have, in effect, given the other side of the argument on that.

Mr. MORSANI. Thanks.

Chairman LAFALCE. I didn't mean to answer the question. Mr. Morsani.

Mr. **Morsani**. Well, it would be very easy to agree with the assumption that we must protect the steel industry or the others, but I think that because of specific problems——

Chairman **LaFalce**. The question was not should we protect them. The question was should we try to retain, have such industries, and then the question would be, well, what do you do in order to bring that about?

Some people would say protection alone. Others would say let's have some type of strategy for these industries which would have macroeconomic components for all industries and microeconomic components for the industries you are attempting to deal with so they can have a successful adjustment, which would include a great many things. It would include, of necessity, contracts.

Mr. **Morsani**. The composite industry wasn't even heard of a decade ago. We are still learning about the composite industry. If possible, had it been decided the composite industry was not going to be viable, that it is just some fellow in his garage putting things together; do you say there should be a steel industry and that the composite industry shouldn't take the place of the steel industry? It is a little like the ceramic engines that are in production in some nations, and yet we are 5 to 8 years behind ceramic engines and other ceramics.

Chairman **LaFalce**. By composite, you mean a materials industry?

Mr. **Morsani**. Yes. If you are a fisherman, the graphite fly rod is an example, and the seats in aircraft which are composites, which they used to be all metal until they found out they could make them lighter and [illegible]er and more efficient and so on and so forth. I mean the danger is it is so easy—one wants to agree—in the aggregate, we should have an industry, whatever it is.

Chairman **LaFalce**. What part of adjustment strategy for an industry would be needed to convert it from exclusively steel to composite and to provide some type of adjustment assistance if need be, whether it is time or money or, you know, whatever it might be? Wouldn't it be a good idea for the Government to work with all industries and labor to try to bring about this type of adjustment? So that while the steel industry is contracting, it could be changing and converting in part to a composite industry?

Mr. **Morsani**. Of course, you are correct. And one of our problems in trade, we have had certain industries, even our whole industrial complex a very few years ago—as an example, Japan was changing its industrial complex every 17 years and our industrial complex had not turned over in 37 years, and we were not addressing the changes in the—I use the composites again only as an illustrative industry.

Should government play a role in moving from one industry to the other? You see, in moving from one industry to the other, maybe. But would policy end up really moving from one industry to the other, or would it end up protecting the industry that had been in vogue because of lack of change?

Chairman **LaFalce**. So as long as man is acting, we have the possibility for good or bad, to be sure. But the point I am attempting to make by this hearing, Mr. Morsani, is what we are winding up doing, in fact—according to your testimony, according to Ms.

Stern's testimony, according to Mr. Cline's testimony—is adopting an exclusively protectionist policy. We are doing what you fear we would do, and, therefore, it seems to me we need an alternative.

Let me move on. My time has expired, and I want to give all members of the subcommittee a full opportunity.

Mr. Lundine.

Mr. **Lundine**. Thank you, Mr. Chairman.

I would like to ask unanimous consent that we be allowed to propound written questions to the witnesses, particularly Ms. Stern. I would appreciate if you would respond to a couple things. I know I am not going to have time to ask in writing.

Chairman **LaFalce**. Without objection, so ordered.

Mr. **Lundine**. I would like to say it seems to me that every other country in the world has a trade strategy, and we don't have any. Ms. Stern said, I think I got the quote correct, that we have no consensus on adjustment. I say we don't have any consensus on anything with respect to trade. We have ideology, but we have no policy, and I wish to associate myself with a concluding comment of the chairman.

Now, in deciding among all the questions that I would like to ask, I must say I agreed with virtually everything in the analysis of Ms. Stern, much of what Mr. Morsani said and very little of what Mr. Cline said, so I want to talk to Mr. Cline.

Essentially you said the rise in protectionism is caused by the dollar, and the solution is to lower the budget deficit. The cause, in my judgment, is that we have no alternative strategy, none. The solution that you point out seems to me to ignore a couple other factors. You can't go along with a very small savings pool and large investments, including public budget deficits, without having an adverse effect.

But it seems to me that as important as budget deficits are, it is simplistic to say that they are the whole explanation of the dollar dilemma, is it not? I mean, your comment first with regard to the fact that the dollar is the whole cause of the protectionist sentiment, and, second, with regard to the solution to the dollar being more or less exclusively the Federal budget deficit.

Mr. **Cline**. I would say that by far the most important cause of the rise of the dollar has been the policy mix of large fiscal deficits combined with the monetary policy which attempts to avoid monetizing those deficits and getting high inflation.

Mr. **Lundine**. You don't think our savings rate has anything to do with it?

Mr. **Cline**. Let me give you some figures on that. As I read the savings investment imbalance, what has happened over the last few years is that, yes, we have had a growing shortfall in resources compared to our absorption in investment plus Government deficit. But the shortfall has come solely from a fiscal bust rather than an investment boom. Let me give you those figures.

Investment in this country has hovered at about 16 to 17 percent flat for the last several years. It went down obviously in 1982 with the recession. The fiscal deficit rose as high as 4 percent of GNP in 1984. Savings, personal savings, is too low, but it has been relatively constant. Business savings has been relatively constant.

So as I read the figures, yes, if you need a single thing to blame it on, I will blame it on the deficit.

Mr. LUNDINE. Isn't that the point, though? In 1981, we took a risk in this country that cutting taxes would encourage substantially greater savings, and it didn't, in fact, occur. We basically spent the money, right?

Mr. CLINE. That is right.

Mr. LUNDINE. As soon as you mentioned the surcharge, and I think you were talking about the dollar being 40 percent overvalued, the next words I think that came out of your mouth were "economists say," which caught my attention. Economists have also been saying for 3 years that the dollar inevitably would fall with the mix of policies we have had, and it hasn't happened, right?

Mr. CLINE. I don't think that economists were saying with the kind of fiscal deficit that we still have and the monetary policy, that we would necessarily have obtained the decline of the dollar yet, but, yes, I will certainly plead guilty to having been one of those who thought the dollar would come down sooner than it did.

Mr. LUNDINE. I don't think you are distinguished. Almost every economist in America has been suggesting that. And eventually you are going to be right.

You also said that protection is widespread in this country, and it is very costly. Wouldn't you agree that we are less protectionist than almost any other advanced industrial nation?

Mr. CLINE. Well, I have tried to put together some figures on that in a book I published that just came out from Brookings Institution last year, and if you look at the overt protective barriers, discretionary licensing, quotas, et cetera, it turns out that in terms of the fraction of the market covered by protection—and that doesn't tell you anything about the intensity of that protection admittedly—but in terms of the market covered, we are not holier——

Mr. LUNDINE. I agree with that, and this is what has us thrashing around here in Congress. We have come to believe it isn't overt—we are a society of laws. I am not impressed with 19 point plans or 1,800 items that get reduced into tariffs if we don't sell anything more. We have the feeling, although we can't quantify it, that while everybody else has a strategy of protecting their domestic markets in what they consider to be growth opportunities, the United States has no strategy, and all we have are a lot of lawyers that are being employed by foreigners, as well as Americans arguing before the body trying to make the decisions.

Mr. CLINE. I think you are certainly right. Japan, in particular, supposedly uses a lot of methods to protect its market. But if you look at the figures, once again, they are not that impressive. Japan has a higher ratio of imports to GNP than we do. They have 11 percent import to GNP, our ratio is 9 percent. If you draw a line relating the ratio of imports to GNP across countries, they are more or less in an international pattern for a country of their size. They have a low ratio of manufactured imports, but that is primarily a reflection of the fact that they have virtually no natural resources. They have got about 300 people per square kilometer——

Mr. LUNDINE. Wait. You used the comparison of Japan and Canada, and that is another thing I want to take exception with. Japan imports raw materials and exports manufactured products. Japan doesn't import Korean steel when it is cheaper than Japanese steel, you better believe they don't. And you are right—I am glad you made that distinction, they have a very very low ratio of import of manufactured products.

Now, yes, they need to import raw materials, but, do they need to protect themselves from manufactured products? With Canada, by contrast, our deficit exists and it may be higher on a per capita basis than Japan, but we are not as concerned about it because it seems to us that we are not acting like a colony where we export raw materials and import finished products.

Mr. CLINE. I would simply say that in terms of what countries can produce, what resources they have and where they have to specialize, comparative advantage, to my mind, it is quite natural that Japan would be more competitive in manufactured goods because basically that is all they have the resources to produce, whereas we have a very substantial portion of our exports in agriculture, other raw materials. So whereas you look at the data and read protection as the explanation for their low ratio of manufactured imports, I read those same data and conclude that it is perfectly explainable by the resource endowment of the country and their comparative advantage.

Mr. LUNDINE. I keep pleading with the chairman for one more follow up. I mean it this time. I will go on record. You don't think they are protecting themselves unduly—forget about America—from products of developing countries like Korean steel? You don't believe that is true?

Mr. CLINE. I suspect, yes, there is some. I suspect it is rather more complicated than to call it protection. It has to do with oligopoly, there is some of that, yes. But I think the perception of Japan as having a radically different threshold of protection compared with really open markets here, and in the case of our English-speaking friends to the north, very much overdoes the reality.

Mr. LUNDINE. Thank you, Mr. Cline, and thank you for your patience.

Chairman LAFALCE. You may proceed.

Mr. GROTBERG. To any one of the witnesses who may care to respond, as a layman in international trade affairs, the deficit number has always been a concern to me. I don't know who puts it together. Every night some gremlin somewhere adds up today's losses.

First of all, is that a fact? Where is it done?

Ms. STERN. Are you talking about trade deficits?

Mr. GROTBERG. Yes.

Ms. STERN. It is done at the Department of Commerce, and it is based on Customs Service collection, I imagine.

Mr. GROTBERG. I will ask quick questions if you keep giving me quick answers.

Like you, Mr. Morsani, I have dozens of industrialist friends who started 15 years ago, went to Korea and bought their own factories. I am thinking of Mr. Weyer, who owns Chicago Roller Skates. He is just one example. Are the trade numbers ever laundered to deduct the dollars that still wind up in the American economy by the many, many people who have gone overseas?

I have Caterpillar in my district. I recognize gross numbers are gross numbers, nothing is going to change them. Does anyone ever launder them for the net effect on the American economy? A lot of those dollars may be in the foreign deficit, but they come over here and are American dollars—they may not hire as many people. I am not suggesting the payrolls don't go down.

Mr. **Morsani**. I can't answer that question. Mr. Ron Utt, an economist with the U.S. Chamber, may be able to answer that, or Ms. Stern or Mr. Cline.

Ms. **Stern**. The big number includes both the imports that are being brought in by U.S.-owned manufacturers who have gone offshore, like Caterpillar, who are bringing in components to finish the finished product in this country. It includes those footwear producers who have gone over——

Mr. **Grotberg**. They are bringing in their own value, Ms. Stern.

Ms. **Stern**. Moreover, it also represents foreign-owned producers——

Mr. **Grotberg**. That, I understand. I, John, own a factory in Korea, and the dealing is done in Korean exchange, I understand that. It gets put in the total. But when I convert, I have got American money in the American economy, and it is such a huge factor—so many people have gone offshore, I still don't know for sure—you haven't told me for sure if the net dollars at the end of every day at the Commerce Department are adjusted in any way for what turns out to be American dollars after all.

Ms. **Stern**. I do not believe that they are adjusted. We at the International Trade Commission, when we are looking at a specific industry, can gather data and do gather data on how much—when we ask the domestic producers what they are importing, so that we know what the imports are in the footwear industry, and we know how much of these imports are being brought in by domestic producers themselves, so we have a darned good idea who is doing what, bringing it in.

Mr. **Grotberg**. Is it a significant number?

Ms. **Stern**. In footwear it is very significant. A large proportion of the imports that are being brought in are being brought in by domestic producers. The question then becomes, is that a sign of injury or is that a sign of adjustment? That gets into the questions we have to deal with.

Mr. **Morsani**. There is a case in the automobile industry, a great many components are manufactured by partially owned subsidiaries, whether it be in Great Britain or Japan. I can't answer from the economist's standpoint, but I don't know how that—I understand your question.

Mr. **Grotberg**. I think it is a pretty good question for a layman. I think in a sense the Georgetown University gentleman can add your comment to it. Can I believe the net deficit?

Mr. **Cline**. First of all, it is the Institute for International Economics. I think the point you are broadly making is there is a lot of economic activity that involves multinational corporations that doesn't get captured in the trade data. What the data represent is nothing more and nothing less than the physical crossing of goods across the border and the values of those goods.

We obviously have multinationals that are active in Europe and Japan. Our trade figures do not include, for example, the production of GM automobiles in Brazil or in Europe.

Mr. GROTBERG. Thank you. I think I had better go vote.

Chairman LAFALCE. The subcommittee will recess for approximately 10 minutes.

[Recess.]

Chairman LAFALCE. The subcommittee recessed as we were about to call on Congresswoman Kaptur. Ms. Kaptur.

Ms. KAPTUR. Thank you, Mr. Chairman.

I also want to express my appreciation to the witnesses for their extremely informative testimony, and like my colleague, Mr. Lundine, I wanted to compliment a couple of the witnesses and then move on to Mr. Cline.

I wanted to thank Ms. Stern because I think your discussion of adjustment in the current world situation and in the trade situation this country faces is extremely important, and I think you moved the discussion a little bit further along the road. I am glad the chairman of the Trade Subcommittee was here to hear some of that testimony.

Mr. Morsani, on behalf of the chamber, I would thank you for your testimony, especially the part that dealt with your efforts in leading a delegation to China and in trying to open communications to India and to keep communications open and to deal with some of these other nations on the trade question.

I must say, however, what troubled me about the chamber's testimony was it had too much of a business-as-usual attitude about it. I specifically wanted to point to page 12, where there was a reference made to the chamber's interest in development of commerce within the Pacific Basin because the chamber feels they have dynamic market-oriented economies there. I think that I would disagree—I wouldn't put an Adam Smith label on those economies of the Pacific Basin Region, and I would hope people doing work at the chamber would read some economists beyond Adam Smith. We have come 200 years now, and the world has changed a lot, and it all isn't quite as nice and neat as his theory might suggest.

The only other comment I would make on the chamber testimony is I think it is very dangerous at the beginning of the testimony to lump aggregate figures together when trying to describe what is really happening here in America. I was thinking back to an analogy of college kids in Ohio, from Ohio State. Some of them end up as freshmen in college, but they can't meet the basic requirements. What the State Board of Regents has done is they have gone back now and have actually been tracking why some students don't make it in college. They have gone right back to the high schools from which they came, and notified the principals of those high schools, and there is a pattern developing of certain high schools producing certain students that don't make it at the college level.

I think it is very important for the chamber to begin disaggregating this data and look at what is happening to certain sectors of the American economy, because I would like to argue that what we have to be concerned about, as Members of Congress, is that what makes a successful company is very different from what makes a healthy nation and that part of what makes a healthy nation is an understanding of what is happening in the various segments of our economy, and we just can't use aggregate numbers to describe that.

I basically wanted to get on to Mr. Cline because, coming from Ohio, I think the Institute you work for has a lot of influence here in Washington. I am not sure if it is disproportionate or not, but I wanted to ask you, who funds your institute? Who is on your board?

Mr. **Cline**. We are funded primarily by the German Marshall Fund, which is a foundation established by the German Government a number of years ago in gratitude for aid they received from the United States. They were our founding funder.

We now have also funding from Ford Foundation, Rockefeller Foundation, several corporations. The chairman of our board is Peter Peterson, former Secretary of Commerce. David Rockefeller, Alan Greenspan, Mario Simonson from Brazil, among others, Tony Solomon, are members of our board of directors.

Ms. **Kaptur**. I don't know some of those people, but which companies do they represent?

Mr. **Cline**. Of course, David Rockefeller has been associated with the Chase-Manhattan Bank; Pete Peterson was the head of Lehman Brothers Investment Bankers. He is now starting his own investment banking firm. Alan Greenspan is, of course, a former Chairman of the Council of Economic Advisers and is an economic consultant and analyst. Tony Solomon is a former head of the New York Federal Reserve Bank, he is now retired. I could name others.

Ms. **Kaptur**. Who was the person from Brazil?

Mr. **Cline**. Mario Simonson is the former planning minister of Brazil.

Chairman **LaFalce**. Finance Minister.

Mr. **Cline**. That too. I think he was both.

Ms. **Kaptur**. Thank you very much for that.

I wanted to disagree with some arguments you made here dealing with the cost to the American people of protection, because this is something I have looked into very carefully. Coming from an area that is heavily dependent on the automobile industry for its future, I began looking at the figures on auto import restraints and trying to estimate what had actually been included as the factors in the econometric models that they put together to estimate those numbers. Let me say that after doing that, I have serious doubts as to whether those numbers are believable or not. And you include some others in your testimony.

I guess I would want to argue the other side, that I think the models used in estimates as to those price structures and costs are seriously flawed. The reason that I feel that is because I do not feel the models capture all of the factors that are contributing to the market price in the given situation. In fact, I drafted a bill in the Congress asking the International Trade Commission and others to do a better job estimating what these price differentials really are. I felt when I looked at the models—you have Alan Greenspan on your board, that I should encourage you to go beyond Mr. Crandall's estimate.

If one looks at the cost of capital between two societies and how that is incorporated in the average price of an automobile—and there were certain measures of productivity I think one can relate to the cost of capital—one will find differing interest rates and cost of capital in some countries are included in that price and in others these factors are hidden or are ignored.

Another factor is taxes. I think that if one carefully looks at the ways in which those numbers were put together, one can really doubt whether or not taxes were incorporated in a similar way in the nations that were being analyzed.

Finally, I think the way the chain of supplier costs are added to the final price of the product is questionable. I could go on—there are many other factors. I think what really bothers me is that, if you look at a period of time and at the investment that Japan might have made in an automobile plant that made it more productive over time, the productivity was higher, and that is reflected in the price. I think the price measurement becomes quite difficult, and I think some of the measures that were used are arbitrary and incomplete.

Yet this study is always used when one wants to hit the American automobile manufacturers over the head. I think Mr. Crandall's research, coming from Brookings, has had undue influence in the argument, and, quite frankly, I think we need more debate. I think you will probably go on his side, and I need to find other scholars to go on the other side.

I think the calculation of price is extremely important, and I really don't think the measures are very sophisticated, and I would believe most economists who would take a serious look at some of the models being used there would have to agree.

I don't have quite as much confidence as you do in the numbers that you offered this morning. I wish we did have a mechanism in this country to really compare price, since that is the ultimate measure of competitiveness in the buyer's mind across national boundaries. I think we need that in this country, and I don't think we have it. So that is just a comment.

I wanted to move on to something I think is important, and that is the relationship between the high dollar and the U.S. deficit.

Chairman **LaFalce**. Last question.

Ms. **Kaptur**. Last question, OK. I don't agree with your assessment that 90 percent or 85 percent of the value of the dollar is related to the U.S. deficit. I think that about 50 percent of the high dollar and ultimately the trade deficit, can be attributed to the budget deficit, as a guesstimate.

I think what troubles me about your analysis is that you only start in 1980. I don't really think that the analysis that you provide is totally helpful in understanding what is happening in some of the key sectors of the economy because again you use the aggregate numbers. I think if you really look at the trade deficit, you will find it began in certain sectors way before we entered this period of the 1981 tax cut and what people have been talking about here.

I think the best analysis I have seen of that is from out in Berkeley, from the Berkeley Roundtable on the International Economy. They really do disaggregate this data. Knowing how much time you spend in Washington, I would encourage you to take a look at some of their work. I think it is a little more complex and thought provoking.

Thank you, Mr. Chairman, for your indulgence.

Chairman **LaFalce**. Thank you. I do feel the subcommittee could benefit by having the witnesses comment on Ms. Kaptur's comments.

Mr. **Cline**. Surely. Let me first say I do intend in my work program to do more detailed analyses of the cost of protection and the whole question of viability of the industries in the auto sector and textile-apparel sector and in steel.

I would point out that a number of independent entities have reached similar kinds, qualitatively, of conclusions about the high cost, primarily to the consumer, of protection. I would cite the Congressional Budget Office. Just as an example, their study of steel protection last year came up with numbers more or less similar to the ones I have cited here. The studies I have cited in the table include studies of the Federal Trade Commission.

So I am not sure I would agree with the——

Ms. **Kaptur**. I have looked at those, and I would encourage you to look at the factors, the range of factors that are used in the calculation of price, because I think there are some serious omissions.

Mr. **Cline**. That is a helpful suggestion. I am not sure taking all that into account I would come out much differently.

Now, as to whether the fiscal deficit is 90 percent of the cause of the rise of the dollar, I take it you do agree that the rise of the dollar has added a significant burden for U.S. import competition.

Ms. **Kaptur**. Oh, yes.

Mr. **Cline**. I think it is true over the last 3 or 4 years a number of things have been happening that have contributed to the rise in the dollar. One of them is the fiscal deficit and the high interest rate. There has also been a confidence factor, a sense that in Europe, the outlook isn't very good, so let's put some money in the United States, sort of a push from abroad rather than a pull from the United States.

My own sense is that that kind of thing tends to be pretty short-lived, that, once the investors making those decisions contemplate a U.S. external debt, net external debt of $1 trillion in 1989, which is what my colleague, Steve Marris, at the Institute has projected will happen if the dollar doesn't come down, that they are eventually going to realize the risk of a very sharp drop in the dollar, which will overwhelm the perception of security, greater confidence, more robust outlook. There is nothing like the possibility of a 20-percent decline in a single year to make the 3 or 4 percentage point differential in rate of return pale by comparison.

But nonetheless we are at a particular point in the trajectory of perception and confidence, et cetera, where you are right, there has been sort of a building momentum of this confidence factor that adds onto the fiscal deficit.

In terms of a policy that the Congress can responsibly address, however, the Congress can't do anything about German investors' confidence in the German Government, but they can do something about the fiscal deficit, and it seems to me that is the place where action has to begin.

I would go as far as to say if this confidence and other factors kept the dollar unchanged, as strong as it is even after the sharp reduction of the U.S. fiscal deficit, which is a possibility, I think kind of a remote possibility but it is a possibility, I think we ought to start considering puting taxes on a foreigner's earnings of interest, other capital earnings here in the United States to get this thing turned around. Because it seems to me that the kind of distortion that we are having to our economy is so severe, it has already gone so far that we have to correct this very sharp distortion.

So I agree with you, there have been associated factors that have added to the fiscal deficit. I still think, in terms of the policy handle we have on the problem, that the fiscal deficit is the essential place to act.

Ms. STERN. Mr. Cline, who is an economist, has emphasized repeatedly the fiscal policy. I say this at the risk of being completely disproved, but it is my general——

Chairman LAFALCE. Completely what?

Ms. STERN. Disproved. That it is my general impression our dollar problem—we have always had a fiscal deficit, and what has happened is that it has gotten much bigger, and bigger and bigger. But as far as the dollar's strength growing, that was coincident with rising interest rates, which were coincident with a very supertight monetary policy. That is what really kicked this thing off as far as the trade impact is concerned, and I believe that dismissing the monetary policy solution or part of the solution as saying, well, that will only be monetizing it, printing more money, that will be inflationary, that is not necessarily 100 percent true. There are inflationary factors which can be better controlled, there has been pressure on them in wages. Wages have been constrained a great deal in the last couple of years because of the trade problem, if for no other reason.

There has been a fixation, I think, on fighting only inflation and not thinking about the trade implications and the traded sector. And now that the economy really is slowing down, there is finally some attention being given to growth as having some advantage as well.

So fiscal policy is there, it is true, but I just don't think you can dismiss the monetary policy by simply saying if you look at that particular portion of the equation, you are going to just be monetizing.

Mr. MORSANI. Mr. Chairman, following up on Mr. Cline's point, when you look at why the Europeans are investing here—and I do business in Europe; and I recently made several speeches over there and talked to the business community at large in a number of countries; and when you are looking at 47 percent of the European common market cut, and 47 percent of the GNP of common market countries goes to the government against 32 percent in Japan, they don't have anything to invest their money in.

I think the strength of the dollar, those people who want to bring their money to the United States not for the reasons prior to the last decade. The reasons they were bringing it over before are entirely different than why they are doing it now. That has pumped up the dollar. It doesn't seem to me—I am not an economist, I don't know anything about the profession, but that is hard to be quantitative about. When you talk to the people investing money, that is why they are bringing it over here, because there are no investment possibilities in Europe.

When you look at the jobs, we all know the history, they haven't created any new jobs in 15 years. There is just no investment going on in the business community in Europe, and this is the only country they can put their money in, where things are happening, and that is pushing up the dollar.

I don't know how this relates to the trade deficit problem, I don't know how you can get your arms around that problem. Excuse me. It hasn't been discussed, and I think it is significant.

Chairman LaFalce. I take it Mr. Cline wants to respond.

Mr. Cline. First of all, let me come back to Congressperson Kaptur's statement about the fact we have had deficits in the sectorial level for a longer time than we have had an overvalued dollar. I agree with that. I think what we are witnessing today is the whole tide level——

Chairman LaFalce. Could you speak into the microphone a little more?

Mr. Cline [continuing]. So that a lot more industries are being caught into severe pressure from imports. Even if the dollar came down substantially, some of the more hard-core problem sectors would remain. Their problems would be less severe, but they would remain.

Chairman LaFalce. Their problems would be primarily microeconomic problems.

Mr. Cline. That is right. That is exactly right.

In illustrating your point, you said after all, we have had a deficit with Japan for a long time. That is completely correct. We tend by nature to have a structural trade deficit with Japan and because of triangular trade, essentially because Japan has to import a lot of oil, much more proportionately than we import, they tend to have a global balance in their trade that works out to a triangle, where they import more from OPEC and export more to us.

My calculations show the basic point of triangular trade can account for something like a $10 to $12 billion bilateral United States-Japan deficit today out of the total of about $37 to $40 billion. But the total deficit has risen much beyond what can be explained by triangular trade. Japan's trade surplus with the United States was only about $8 billion, $9 billion in 1979 to 1980, and it has mushroomed to $37 to $40 billion.

You are completely correct, there are these microproblems that exist despite the exchange rate, and also there is this phenomenon of which countries we deal with. They exist regardless of the exchange rate. What is new is the intensity of the magnitudes that go beyond that.

Now, Paula Stern essentially took on Mr. Volcker—I am not sure whether I want to take on Mr. Volcker. I guess Mr. Volcker was facing extraordinary——

Chairman LaFalce. Mr. Martin is willing to take on Mr. Volcker.

Mr. Cline. We certainly saw what happened there. The Fed was facing deficits, and it was coming out of a period where inflation was as high as 14 percent a year. Money was tight, and that was part of the equation, I agree. It might have been possible to engineer it so it wasn't tight. Each time it looked like it was going to push the situation over the brink, the Fed backed down.

In 1982, with the Mexican debt crisis, the Fed started pumping up the money. Just this last year, we saw the transition as the Fed saw these numbers coming in on a weaker economy, and the last couple quarters the M1 figures are above that little cone that says where they are supposed to be.

So for that reason I am not really prepared to lay quite as much of the blame at the door of the overly tight monetary policy as opposed to a fiscal deficit.

Ms. STERN. That is your response to the general growth in the economy, but the point is the traded sector, the impact on the traded sector. We have $123 billion trade deficit, we are here for this reason, to discuss that, today. So you can say that—in terms of inflation and in terms of growth, we may have just the right prescription, perfectly fine-tuned, but then there is this whole traded sector situation. And to me, you just can't talk only of fiscal policy and say, well, the monetary policy had nothing to do with it. You may say in the end you did the right thing, but the point is you have had a consequence of that thing, of those decisions, and that is our $123 billion trade deficit.

Mr. CLINE. I think you and I could have an interesting seminar on the traded goods portion of the economy. I am not sure this is the time to do it.

Chairman LAFALCE. Let us enter into some kind of informal pact between the President, the Congress, and the Fed—not something signed in ink or blood—but only if the President would be willing to increase revenues, and then the Congress might be much more willing to reduce expenditures, and then the Fed would be much more willing to liberalize its monetary policy. It would seem to me all of those things are so desirable, and it takes no omission to see the wisdom of them, that we would all do them.

But when you start off with some nonstarters, such as no increase in taxes, no reduction in defense spending, it makes it difficult to enter into any bilateral compact, much less a trilateral compact.

Please continue.

Mr. CLINE. I would agree with that. It would seem to me, I would like to see the Conference Committee come out rather differently from what people have said.

Chairman LAFALCE. It doesn't look like a compromise is coming out.

Mr. CLINE. I would like to see a compromise in which each side gives; the House accepts the Senate's cutback——

Chairman LAFALCE. The problem with that is they haven't examined the question of revenues. We are off on a political side-show distraction about tax reform right now, pretending it is revenue neutral, and that that would be good when the fact of the matter is we are going to have to deal with the budget deficit, which would greatly facilitate Paul Volcker's and the Board's ability to have a more flexible monetary policy. Query—whether they should have a more flexible one now, given the trade deficit, despite the huge budget deficit, which clearly it would facilitate their—pardon?

Ms. **Stern**. The time has passed in a way. The monetary policy decisions are much more constrained, given the fiscal policy situation. The time is during a period of recovery, which has passed.

Chairman **LaFalce**. We had better give Mr. Dreier a chance.

Mr. **Dreier**. Thank you very much.

I have been enjoying this. It is not a sideshow here at all.

Chairman **LaFalce**. I was talking about the Presidential sideshow.

Mr. **Dreier**. I see.

Chairman **LaFalce**. It is called the politics of distraction.

Mr. **Dreier**. Article I, section 7 of the Constitution clearly states that revenue raising has to initiate not at the White House but in this body, not over in the Senate either, but in this body.

Chairman **LaFalce**. Come on. Get off of it, Mr. Dreier. Sure, we have to start it off in the House, but when the President says, "Make my day, give me a bill so I can shoot it down," that is a nonstarter.

Mr. **Dreier**. You are right, it is a nonstarter, but I certainly have to make it clear the President is not the only one who has to agree to some kind of tax increase.

Chairman **LaFalce**. Sure, we can say the President is not a Member of Congress. I will stipulate to that.

Mr. **Dreier**. I would like to, since we are talking about the deficit question, first of all, let me say I congratulate you on calling this spectacular hearing. I have enjoyed the testimony.

What I would like to pursue along the deficit line is the fact—we have discussed the Chairman of the Federal Reserve Board. Chairman Volcker has repeatedly said a $50 billion reduction in the deficit will in fact maintain, possibly enhance, the economic recovery, and in light of Mr. Cline's quoting his colleague, Mr. Williamson, regarding the 40-percent overvaluation of the dollar, I would like to know what size reduction in the deficit you believe would be necessary to counter that 40-percent overvaluation.

Mr. **Cline**. It seems to me—first of all, I should say——

Chairman **LaFalce**. Let me interrupt you for a second.

It is my understanding, Mr. Morsani, you have to go, and you had to go a half-hour ago. Let me excuse you right now so you can make your——

Mr. **Dreier**. I had eight questions for Mr. Morsani. I am being facetious.

Mr. **Morsani**. I am sorry. I appreciate having been here.

Mr. **Cline**. First of all, let me make it very clear one of the murkiest parts of this whole mechanism is the direct impact, first of all, of the deficit on the interest rate, exactly how many percentage points for how many billions of dollars.

Mr. **Dreier**. You didn't seem to think it was murkier earlier. Maybe there is a question on the figures. But you have directly stated here this morning there is a very close association.

Mr. **Cline**. Right. I can certainly give you the sign. The exact magnitude is less clear.

There is also a murky relationship between exactly the reduction in the U.S. interest rate and the eventual reduction in the dollar, partly because foreign countries may choose to follow our interest rates down rather than to keep their interest rates where they are. And, therefore, the interest differential would still be as big as it was before.

Now, that being said, it seems to me that we basically have to have a large and convincing reduction in the fiscal deficit, and it——

Mr. DREIER. Would you agree with Mr. Volcker's $50 billion figure? Do you think it should be more or less?

Mr. CLINE. I think we have to be talking about reducing the deficit by $100 billion a year.

Mr. DREIER. Before it will have an impact on that 40-percent valuation?

Mr. CLINE. You could get some impact with a $50 billion cut, but I don't think you would get at the bulk of that 40 percent unless you made a very major assault on that deficit.

Mr. DREIER. I represent southern California, and we have talked here today primarily about three particular areas in question—automobiles, textiles and footwear. Those are the items we have touched on. I, like all three of the witnesses, take a very pro free-trade tack. But I have to say that I have been listening to some extraordinarily compelling arguments about the textile industry and the fact that a million jobs are at risk, and the most impressive arguments have been the fact the industry domestically has made all of the advances that it possibly can in the area of equipment and meeting all of the potential technological advances possible.

What I would like to ask both witnesses is: Do you believe that there is a troubled industry that could see us impose some kind of protectionist act that would not in any way damage overall trade questions?

Mr. CLINE. You are saying, would it be possible to give the textile, apparel——

Mr. DREIER. I am asking any of the industries at all that are considering protectionist acts.

Mr. CLINE. We have a recommendation to put some restrictions on footwear, and I think that the thought there would be that that wouldn't necessarily touch off a trade war. It does seem to me that the real risk is that you have a proliferation of such actions, and in particular that you bring in some very big sectors, like textiles and apparel, and that eventually the critical mass gets to the exploding point.

Mr. DREIER. Which industry do you think most needs some kind of protectionist tack?

Ms. STERN. I would like to answer your first question, and then I will try to answer your second one, too.

Any time the economy intervenes, for whatever reason, to help one industry, it is like a balloon: If you push it at one place, it is going to pop up in the other.

Mr. DREIER. I understand that.

What you are arguing is that there is no industry in this country that really should, even though you alluded to footwear earlier?

Ms. STERN. Exactly. I think we are talking—that is what I said. Section 201, which I administer, is a middle ground between total nonintervention—which means elected officials—and our political body politic—will ignore pain that is disproportionate in certain areas and intervention to try to plan everything.

I believe that there are two answers here. One is a purely economic answer, and the other is one which is rooted in the fact that we are a democracy, that we have interest groups, that we have elected officials, and that we have times when we have, as a body politic, prescribed when we will step in to help an industry. So there are two answers there.

Now, to answer your second question—which is, which industry is the most harmed—is that by imports?

Mr. **Dreier**. By imports, right.

Ms. **Stern**. Well, last——

Mr. **Dreier**. Let me ask it a little differently.

Which industry creates the greatest jeopardy to jobs in this country because of imports?

Ms. **Stern**. That is something else. I mean, we have had some industries where there are more jobs than others. Then there are jobs which you don't want to protect. There are jobs which—for example, people are leaving; they are there because it is their first entry job or it is a job that is very, very low paying, and they leave it for a better job. So, it really depends.

Mr. **Dreier**. We say we wouldn't want to protect them, but why would we not want job opportunities to be available regardless of where they are in the economic spectrum?

Ms. **Stern**. If the economy is dynamic and is growing, we want to have jobs available in the dynamic areas where we have a comparative advantage and where the comparative advantage is reflected in the fact that the wages should be more attractive. That presumes that you do not have any kind of rigidities in the economy.

It is a very hard question to answer. You could answer it by just saying which industries have the most number of jobs. But then I think you have to break down what the jobs are paying for and has that industry been protected all along; and, therefore, are there rigidities there which, if they weren't protected, the industry would disappear.

There are so many different industries, and each one has different idiosyncratic characteristics.

Mr. **Cline**. I simply wanted to make the point, it seems what we need is to have a mechanism that goes beyond putting up a new round of protection; that really does encourage adjustment.

One of the proposals that some of the work at our institute has come up with—by Gary Huffbauer—is that when we do have protection, that it be in the form of either tariffs or quotas that are auctioned, and that the revenue, either from the tariff or from the quota that is auctioned, be committed to a program of adjustment.

As Paula Stern said before, you have to accept the idea of downward adjustment in combination with increased productivity. In other words, it seems to me there has to be a view in the industries that seek protection that they will tighten their belt; that they will cut back in their total size. If we had resources, for example, from a temporary tariff committed to the transitional costs—some of these can just be terminal benefits for workers who are going to be displaced—then I think we would have somewhere to look forward to in terms of an adjustment process, rather than having recurrent protection.

The textile/apparel protection unfortunately started out as temporary in the early sixties, and it has become virtually perpetual precisely because it doesn't have any commitment built into it to phase out.

Mr. **Dreier**. Maybe I could shift to the question of Japan for just a moment.

I had a prominent Toyota dealer in my office 6 weeks ago from southern California—that is not the only reason he is prominent. What he said to me is—we are all aware of the $37 billion trade deficit, but he said, "We have got to realize that while many domestic auto manufacturers and dealers stand up and protest that, yes, we are all for free trade but we want fair trade and we want their markets to be as open as ours are." And yet, the argument he makes is that while Lee Iacocca can say that, he has never produced an automobile—Chrysler has never produced an automobile—which could possibly apply to the Japanese market. For instance, they drive with the steering wheel on the opposite side, and there is not a domestic manufacturer in this country who has created a unit which could meet the requirements there—not regulatory requirements or import requirements, but simply market requirements.

I wonder what your thoughts are on that?

Mr. **Cline**. I think that is right. I think American manufacturers calculate they couldn't reach the necessary scale even with the best market penetration possible in Japan.

Mr. **Dreier**. In light of that, do you think it is unfair for them to raise those questions and talk about the fact that their markets are not open to our products?

Mr. **Cline**. As my studies indicate, the weight of the perception that Japan is unfairly trading is vastly exaggerated. So I agree with you. We see, I think, a manifestation of that.

I believe there is now pending legislation to institute reciprocal inspection methods on Japanese automobiles that identically mimic what the Japanese do as if the inspection barrier is the only reason we don't have lots of Cadillacs and Chryslers in Tokyo. I would submit that that is a misperception of the problem.

One of the problems is this limited concept of reciprocity where a country is not fair if they are not importing from you what you import from them. The illogic behind that is illustrated by asking whether Argentina would accuse Canada of being unfair because Canada doesn't import Argentine wheat.

Ms. **Stern**. I would simply say on the auto case, I concur with Bill Cline. I don't think, however, we should ignore there have been other market opening difficulties that we have had with Japan, and I point this out——

Mr. **Dreier**. The automobile industry is the one most prevalent in Japan.

Ms. **Stern**. I think the focus, for example, on satellites might be better taken. Specifically, they were interested only in importing the components, even though they had not been making the satellite over there, rather than purchasing satellites from us who produce them.

I take note that last week there has been a final purchase order placed on satellites after a number of years of discussion.

Mr. **Dreier**. I have also been told that in Japan their regulations require a certain pitch for the tone on the telephones that are used there. But it has also been argued those constraints are imposed on their domestic manufacturers as well as the imports.

Ms. **Stern**. I simply don't know the facts on that.

Mr. **Dreier**. Just one other item also relative to Japan.

I have argued—this is my fifth year here, and I have argued for defense sharing with both Japan and West Germany. And as we are addressing the overall deficit question, I would like to have both of you briefly address the prospect of requiring the Japanese Government in some way to pay for a greater percentage of its defense. While I know their participation has increased dramatically over the past 5 years, it still is not to a level that I believe is appropriate.

I am wondering if you think that defense sharing would in any way address the trade problem that exists, the $37 billion figure?

Mr. **Cline**. It seems to me, particularly in light of the fact we were the ones who put it into the Japanese constitution, that it wouldn't be too good an idea for them to rearm; that it is going to be difficult for us massively to increase Japanese defense spending on their own, let alone send them a bill for perhaps the difference between the President's proposal on defense and the counterproposals.

Mr. **Dreier**. That wasn't my question, Mr. Cline. What I was asking was whether or not you believe if they were to pick up a greater percentage of that spending, if it would have a salutary impact on the trade problem.

Mr. **Cline**. OK. Let me answer that by pointing out that the Japanese fiscal policy, in which defense is one of many expenditures, has been moving in a tightening direction; and that is a problem. This is a problem not only with Japan but also with Germany and the United Kingdom.

I think Mr. Morsani was correct in indicating that there has been a lack of buoyancy of investment in Europe and Japan, and that to some extent the money comes here for lack of an alternative. If those countries, as part of a general program for getting international balance, would at least stop the tightening of their fiscal programs, it would—yes, indeed, it would help the problem.

So the answer to your question is yes; although I wouldn't put it in defense sharing. I would put it as a general statement about the Japanese—I think it would make more sense, to my mind, to see them spend money on their housing infrastructure.

Ms. **Stern**. I agree on the fiscal point. I think, just as we have been trying to emphasize, the macroeconomic fundamentals in your policies, we should be looking at theirs as well, rather than just focusing on sectorial items.

On the defense question, I won't get into the politics—that is not your question—but I would just simply point out that you have to ask: Do you want them to be producing their own defense goods, or do you want them to be purchasing directly from us? Because those areas where we have had cooperation with Japan, there has been a great deal of emphasis on coproduction, and it is not going to help us very much in terms of the deficit if the items they are procuring are made in Japan.

Mr. DREIER. If I could just ask one more question, Mr. Chairman. Thank you very much.

What do you believe the impact on the American consumer of the voluntary constraint agreement has been?

Ms. STERN. On automobiles?

We did a study of this at the ITC. You probably have the figures in front of you, Bill.

But it protected some jobs for a while, though many jobs were lost through productivity increases. Far more were lost——

Mr. DREIER. What has been the impact on the consumers?

Ms. STERN. There is no question there was a multiple billion dollar price tag. It raised the price of the imported cars by $1,200, and domestic——

Mr. DREIER. The figure I was given was $1,500.

Ms. STERN. I think it was about $1,200 for imported cars, and about between $400 and $600 for the domestic car. But I can provide that for the record and would be happy to give you the exact figures on that.

Mr. DREIER. So, I infer from what you are saying that you believe that that agreement was wrong?

Ms. STERN. Well, back in 1980 I was part of the majority of the commission at the International Trade Commission which found, that while the industry was seriously injured, imports were not the most important cause of the serious injury to the industry. So I was very chagrined to see that, for the first and only time section 201 was in effect, not adhered to. That was my judgment at the time.

This is 1985. I would have to look at the industry all over again to give you my economic reading of whether this industry is seriously injured by imports.

Mr. DREIER. Mr. Cline?

Mr. CLINE. The figures I cited in my testimony for the cost of the automobile voluntary restraints are taken from Crandall's study. His figure is that it cost the American consumer annually over $4 billion, and as much as $160,000 consumer cost per job saved. There is a range of estimates, but I would think that this would be a good estimate.

Mr. DREIER. Would both of you be supportive of the 25-percent increase which was agreed to a couple months ago?

Mr. CLINE. I guess I am supportive of a phaseout of those voluntary restraints. Whether Japan had any alternative to limiting the first year phaseout to a 25-percent increase, I can certainly understand their concern about a backlash if they had let imports rise by 35 percent instead of 25 percent. But it seems to me we have to be moving in the direction of the elimination of those restraints altogether.

Mr. DREIER. Thank you very much, Mr. Chairman. I appreciate your giving me more than 5 minutes.

I appreciate again the expert testimony.

Chairman LAFALCE. I feel compelled to make a couple of points with respect to the questions and comments that I have just heard.

First, it is interesting to note that the call for voluntary restraints was in 1980, before we began the problem of the overvalued dollar.

Ms. STERN. Absolutely.

Chairman LAFALCE. Let me not say more about it other than that.

Second, both Ms. Stern and Mr. Cline, you can see how hard some Members of Congress are trying to justify protectionism, sometimes by denying the problem—denying, for example, that the consumer bears a cost when protectionist relief is given by attempting to undermine what is fairly universally accepted—not with absolute precision but within certain ballpark figures insofar as cost to consumers is concerned. So we, I think, concede, No. 1, protectionism existed before the overvalued dollar, and it was granted—that was by the Carter administration—no, it was granted in 1981 by the Reagan administration.

So it is a fact of life that has been growing at an alarming rate over the last 4 or 5 years, irrespective of the overvalued dollar, but exacerbated by the overvalued dollar. I think we have to understand that in dealing with it.

Second point: Everybody puts so much blame on the overvalued dollar, but if you look from not the low point in 1980 to the high point in 1985—but if you look to the mid-point in 1980 to the present, which is around the mid-point, 1985—you would see the overvaluation of the dollar differs from foreign currency to foreign currency, and that it has increased least with respect to the end as opposed to any other industrialized country.

I believe that in Japan there has only been a 14-percent increase. I don't mean to minimize the 14-percent increase, but it would seem to me that we ought to recognize that and, therefore, believe that there are causes other than simply the overvalued dollar. There are microeconomic problems, some of which are the protectionist measures of the Japanese, but most of which are, in my judgment, our problem in our being the Federal Government, State governments, government in general—labor, management, academia—in getting our act together and deriving a competitive strategy.

Another point with respect to Japan: I share Congressman Dreier's views that if we are providing for their defense, they should be providing more. Some would argue they do that by carrying a far higher burden of multilateral assistance as a percentage of their GNP than does the United States as a percentage of its GNP. Because it seems it is easier for us to vote for defense in this country and more difficult for bilateral assistance, whether it is at the World Bank or the International Monetary Fund.

The Japanese have been more agreeable to increasing their pro rata share. I don't know if that adequately compensates, but I think it is a factor that perhaps we should consider and maybe even look into a bit more.

Mr. DREIER. Mr. Chairman, I was going to say you are absolutely right; the Japanese have in fact increased it dramatically over the past decade, and their commitment over the past decade, especially in light of the Soviet buildup of heavy missiles, as I believe the SS-18 is and 10-S, and over the past 6 years since the Soviet movement into Afghanistan. Those two items, I have been told, have played a dramatic role in increasing the Japanese commitment and in increasing their percentage of their gross national product for defense.

Chairman **LaFalce**. They are constrained insofar as what they can do. They are constrained constitutionally. And this was at the instigation of the United States.

Where I would find most fault with the Japanese, in addition to the protectionist practices they do have—but we have to see them within the total scheme of things, and I think the United States is in considerable part to blame here—is we are philosophically opposed to a U.S. competitive strategy, but we are almost philosophically opposed to some world strategy. It seems to me you do have to have some world strategy which would call for the United States to have a much tighter fiscal policy; and some of the Third World countries, too, need a tighter fiscal policy.

Other countries, such as Japan, must have a considerably more liberal fiscal policy. That is absolutely imperative. I don't know that the United States, the President, has been promoting that enough, because how can you promote some type of world macroeconomic strategy when you are reluctant to come up with a macro or microeconomic strategy within your own country involving the various sectors?

Those were the only comments I would make. Let me get back to some specific questions.

Ms. Stern, last year's 201 steel case, which ultimately resulted in the current steel quota program, in my judgment, is a good example of what is wrong with section 201. The steel industry got relief without a firm commitment for modernization or adjustment.

Where, in the process of implementing section 201, must there be a more explicit requirement of a quid pro quo? At the ITC level? With the President? Do we need some new mechanism? That is the first portion of the question.

The second portion of the question: We did approve legislation that made some modest requirements you have responsibility for monitoring that, as I understand it.

Ms. **Stern**. Yes.

Chairman **LaFalce**. What is the result of your monitoring thus far? Two-pronged.

Ms. **Stern**. You are right; it was not in section 201. Thanks to the passage of—an initiative on the House side to the provision that there be some understandings as to future investment and privatization, if you will, of assistance to workers who are displaced.

In the existing law, section 201, the petitioners are supposed to state what they intend to do during the period of adjustment to make them whole.

I think some industries have been much more forthcoming than others. I would say, for example, the Ford Motor Co. made a very good presentation. It didn't convince me, but they probably made one of the best presentations. The steel industry I don't think was very specific. So there could be more attention paid in any revamped 201 to get those adjustment plans more articulated and get them subject to a statutory monitoring by the Commission.

Chairman LAFALCE. I really want your help as we address this legislation in the future, in coming up with some appropriate mechanism for conditioning future assistance or, at the very least, recommending the conditioning of future assistance. I think it is absolutely imperative.

Ms. STERN. The recommendation I feel more comfortable with. The actual conditioning, I feel less comfortable with.

Chairman LAFALCE. Maybe we can compromise—a combination mandating it, but leaving the imposition to the President after he evaluates your recommendations.

Ms. STERN. But the problem is even there. You see, in the Carter administration we tried a little bit of that with the porcelain on steel cookware. And the point is, they came back after a year—we were instructed to see this industry after a year—that they were going to get the relief, and it was going to be conditioned—somewhat conditional in the sense they were going to be subject to monitoring within a year. So, they came back within a year.

They didn't do what they said they were going to do. The reason they didn't do it is because interest rates had just shot up dramatically.

Are you going to say we are going to take the import relief away from you because you didn't invest in those lines of production which you said you were going to invest?

Chairman LAFALCE. There has to be an escape valve. It can't be a procrustean bed.

Ms. STERN. That is why I say recommendation I can buyoff on, but conditioning it in the sense it is a quid pro quo: If you don't do what you said you were going to do, we are going to take the import relief. That is a problem for me.

Chairman LAFALCE. You can do it, but still have an escape clause. It seems to me if you put it into law, you would be reluctant to use that escape clause. We should work on that.

Ms. STERN. Your other question was more specific, and it is what has the steel industry been doing? We are in the process of tabulating the responses from the industry, and we will be reporting, at the request of then Ambassador Brock, to the President on that starting in August, and then afterwards annually I think in September.

Chairman LAFALCE. Are you only going to the industries for their responses, or are you going to any outside independent analysts? I am fearful industries can come up with responses that are so colored that they could make inaction look like magnificent action.

Ms. STERN. Well, we will at this point be limited only to the responses from the industry.

I might say that that is basically what colors everything we do. We are used to sending out questionnaires, getting responses, and trying to read the response for better or worse.

Chairman LAFALCE. I am just afraid of that.

Isn't there some other way you can use—not exclusively—certainly you have to go to the industry, but isn't there some outside analysis that has been done or could be done that could also be helpful?

Ms. **Stern**. We will be doing the independent analysis. The data is inevitably going to have to be generated by the industry itself—the figures on how much production, what were your profits.

Chairman **LaFalce**. Is contraction a part of that? Is diversification a part of that, going from steel to composite?

Ms. **Stern**. I don't know.

Chairman **LaFalce**. Should it be? That was one of the problems doing this via legislation. I don't know Congress is the best one. In fact, Congress is probably the first one to come up with any type of adjustment plan. I am not sure the criteria we came up with was the best criteria. That is why it seems to me you do need some institutional mechanism outside the Congress to help out in these efforts.

Ms. **Stern**. I have been given the provision Congress did put in, and it is—I think we will have to see what we come up with. It will be the first time we have done it. I think I would be in a better position to——

Chairman **LaFalce**. Let me suggest to you to not only fulfill the congressional mandate, but it would be wise if you, in your comments, explain what you did and the deficiencies of what you did and how your analysis could have been better if you either were charged with doing more—or if you feel you should do more I don't think that you are limited by the congressional mandate. You might, therefore, in evaluating the efficacy of the congressional criteria, decide that it is inadequate and, therefore, you should go above and beyond that. And I would encourage you to do that, if that is your judgment. At the very least, I would encourage you to look into this.

Ms. **Stern**. I certainly shall.

Chairman **LaFalce**. Why pass papers back and forth if they are not going to serve any good purpose? Not only is it unproductive, it is counterproductive. This could serve as an example of how to proceed in the future.

Mr. **Cline**. I wanted to note an implementation problem in conditionality, and that is that protection exists for the whole industry, but the actors of the industry are numerous firms. You are not dealing with a monopoly. So, you get the problem that you are going to have some actors complying with adjustment, modernizing, and another category of actors that aren't.

It seems to me somehow there has to be—the mechanism has to be tailored so it addresses that. One way that is sort of a brute force way of addressing that is everybody gets a protection for 2 years, and then you review it and——

Chairman **LaFalce**. Is there some more detailed way to do it?

Mr. **Cline**. You see, the alternative approach is one—for example, this idea of committed tariff revenues. Suppose that you made the protection in the form of a tariff and that generates some revenues. Those revenues would then be available for adjustment for those particular firms that had actual programs that were actually reducing their labor force.

Chairman **LaFalce**. In other words, you have been talking about what I have been talking about—proceeding on the direct expenditure side where you can achieve targeting, whereas you can't achieve targeting——

Mr. CLINE. With flat protection.

Chairman LAFALCE [continuing]. Either for flat protection or through the Tax Code.

Targeting is very important, and the best way to achieve targeting, whether by industry or by company, is to use the direct side of the Federal budget.

Mr. CLINE. Right.

I don't want to be understood to be going too far in the general approach of industry targeting, industrial policy.

Chairman LAFALCE. I understand your words.

Mr. CLINE. I prefer my words to go to the particular mechanism where you get conditionality from a protected industry.

Chairman LAFALCE. Of all the witnesses, you are probably the greatest proponent of free trade, Mr. Cline, and you have received criticism primarily from Mr. Lundine and Ms. Kaptur.

Do you think there are any conditions under which you could envision the appropriateness of trade relief, either within the past 4 years or the next couple of years?

Mr. CLINE. Well, it seems to me that one can envision situations——

Chairman LAFALCE. Do you think any of the actions giving trade relief in the past 4 years were justified? If so, which ones? Not that they were perfect.

Mr. CLINE. I guess it is difficult for me to say yes, that there were corrective actions; that they should have been carried out in those ways. I think I would agree that in the automobiles case there was considerable overkill. I continue to be impressed by the statistical results when you test who is getting protection, that it is the big guys who get the protection.

Chairman LAFALCE. The fact of the matter is, we don't have an economy; we have a political economy.

Mr. CLINE. A political economy. And the number of voters is a very important determinant of what sectors get protection. You see it with autos; you see it with steel; and you see it with textiles and apparel.

I certainly do not rule out the idea that you may need to have transitional programs that can involve protection. I would very much like to see us move in the direction of a commitment to phasing these out over time. I think we need to move in that direction in textiles and apparel or we will have permanent protection, and that you need adjustment.

Chairman LAFALCE. Paula, do the standards used under 201 conform with the GATT standards?

Ms. STERN. Yes.

Chairman LAFALCE. I know they conform, but aren't they more strict? Aren't the GATT standards more liberal? Aren't other countries using more liberal standards?

Ms. STERN. I don't know of another country which is transparently imposing the standards that we are. I have heard this argument that it is more liberal; it can be construed as more liberal. I would prefer to answer this on the record after the hearing, because——

Chairman LAFALCE. Fine.

Ms. Stern [continuing]. There is some words playmanship that goes on here, legal words playmanship, and I would like to give you just a better answer.

Chairman LaFalce. I appreciate that, and I will look forward to that.

[In response to the request of Chairman LaFalce, the following information was received from Ms. Stern for inclusion in the record:]

Answer to Question of Congressman LaFalce Concerning Differences Between GATT Article XIX and Section 201 Standards

Article XIX of the GATT (General Agreement on Tariffs and Trade), the so-called GATT escape clause, and section 201 of the Trade Act of 1974 contain similar standards providing for an import relief action. Article XIX and section 201 utilize many of the same terms. Article XIX provides in pertinent part as follows—

> If, as a result of unforeseen developments and of the effect of obligations incurred by a contracting party under the Agreement, including tariff concessions, any product is being imported into the territory of that contracting party in such increased quantities and under such conditions as to cause or threaten serious injury to domestic producers in that territory of like or directly competitive products, the contracting party shall be free, in respect of such product, and to the extent and for such time as may be necessary to prevent or remedy serious injury, to suspend the obligation in whole or in part or to withdraw or modify the concession.

Section 201 of the Trade Act provides for investigations by this Commission—

> to determine whether an article is being imported into the United States in such increased quantities as to be a substantial cause of serious injury, or the threat thereof, to the domestic industry producing an article like or directly competitive with the imported article.

If the Commission makes an affirmative determination, it is to find and recommend to the President the relief necessary to prevent or remedy the injury (or in the alternative recommend the provision of adjustment assistance if such assistance can effectively remedy the injury). The relief provided by the President may be in the form of a tariff or tariff-rate quota (each subject to rate increase limitation of 50 percentage points—e.g., if the present rate of duty is 10 percent ad valorem, the rate of duty could be increased to a maximum of 60 percent ad valorem) or a quantitative restriction (quota—but such a quota must allow importation of that quantity or value of articles entered during the most recent period which the President determines is representative of imports). The President may also negotiate orderly marketing agreements with foreign countries. Relief may be provided for an initial period of up to 5 years and may be extended for one additional period of up to 3 years, and an industry which has received relief may not petition for new relief until 2 years has passed since the termination of the earlier relief.

Like Article XIX, section 201 requires that there be a finding of increased imports, a finding that domestic producers (an industry under section 201) are seriously injured or threatened, and a finding of a causal connection between the increased imports and injury. However, Article XIX uses the term "to cause" and section 201 uses the term "to be a substantial cause". The word "cause" in Article XIX is part of an infinitive, but in section 201 it is a noun. The difference, if any, between the two terms is unclear. Neither Article XIX nor GATT working papers or other documents define the term "cause". Congress defined the term "substantial cause" as "a cause which is important and not less than any other cause" (see section 201(b)(4) of the Trade Act).

Section 201 embodies the third major rewrite of the U.S. escape clause law standards and the question of level of causation has been an important consideration in the drafting or amending of all three versions. In the first version, contained in section 7 of the Trade Agreements Extension Act of 1951 (65 Stat. 74), Congress tracked the language of Article XIX and used the term "to cause" without modifier or a definition. Because of uncertainty on the part of Commissioners as to whether imports had be the whole cause or merely could be part of the cause of injury, Congress in 1955 amended the 1951 law to make clear that imports need not constitute the sole factor in causing injury but needed only to have "contributed substantially" in causing that injury. Congress rewrote the provision in 1962. The Trade Expansion Act of 1962 (76 Stat. 864) followed the "to cause" language of the 1951 law but required that increased imports be the "major factor" in causing or threatening serious injury. Commissioners considered this standard to require that imports be more than 50 percent of the cause of injury. Congress later considered this standard to be too difficult to satisfy, and when it rewrote the law for the third time in 1974 it used the term "to be a substantial cause" in lieu of "to cause" and defined the term as indicated above.

Unlike Article XIX, section 201 does not require a finding of "unforeseen developments". Presumably such a finding would be superfluous since it is unlikely that the United States would have incurred an obligation if it had foreseen serious injury. Section 201 does not require that imports be "the effect of obligations", while Article XIX does. However, section 201 sets a limit on the duration of relief (5 years plus an extension of up to 3 years) and sets limits on increases in tariffs and the restrictiveness of quotas, while Article XIX permits such action "to the extent and for such time as may be necessary . . . ."

Chairman **LaFalce**. Let me say, it has been a pleasure having all of you: Mr. Morsani, who has left; you, Ms. Stern; and you, Mr. Cline.

Let me also say, too, in closing, the high respect I have, not only for the three witnesses who have testified, but also—and I feel compelled to say this—the high respect that I have, as chairman of the Economic Stabilization Subcommittee, for the Institute for International Economics and its fellows, its executive director, and the members of its board, and for what I perceive to be the purity of its positions and statements, lest anyone think this subcommittee should think otherwise.

Thank you very much.

[Whereupon, at 1:10 p.m., the subcommittee adjourned, subject to the call of the Chair.]

[The following statements were received by the subcommittee for inclusion in the record:]

STATEMENT OF GEORGE LANGSTAFF
PRESIDENT
FOOTWEAR INDUSTRIES OF AMERICA, INC.
SUBMITTED TO
THE SUBCOMMITTEE ON ECONOMIC STABILIZATION
OF THE
HOUSE COMMITTEE ON
BANKING, FINANCE AND URBAN AFFAIRS

Footwear Industries of America, Inc. ("FIA") appreciates this opportunity to provide testimony in connection with the Subcommittee's hearing on trade relief measures scheduled for June 26, 1985.

As you know, the U.S. International Trade Commission ("ITC" or "Commission") recently completed its fourth investigation of the U.S. nonrubber footwear industry under section 201 of the Trade Act of 1974, as amended. No other U.S. industry can make that claim; but I would venture that no other industry would want to. The nonrubber footwear industry's repeated recourse to the U.S. import relief laws has a two-pronged explanation. First, we know of no major U.S. industry that has suffered competitive injury at the hands of imports to the extent of that suffered by the U.S. nonrubber footwear industry. A litany of statistics could be cited to support that claim, but perhaps no further proof is needed than to note that the ITC has, in three of its four investigations of the industry, unanimously concluded that the industry was seriously injured or threatened with serious injury by imports. Ours is an industry that has been grievously injured by relentlessly increasing imports, and we urgently need a temporary but effective period of relief from those imports in order to implement the modernization efforts needed to compete internationally over the long term.

Last year, as you know, the ITC rejected the third section 201 petition filed by the industry, finding unanimously that the U.S. nonrubber footwear industry was not then currently experiencing serious injury as a result of increased imports. We were, to say the least, shocked and extremely disappointed at the Commission's determination and found it impossible to reconcile with the clear evidence of injury presented in the case. Had the ITC's 1984 decision been the end of the matter, FIA -- and we believe, many other import-impacted industries -- would have been extremely pessimistic about the future utility of section 201 as a remedy for domestic industries confronted with injurious import competition. The ITC's unanimous reversal of last year's negative injury determination following congressional clarification of the statutory criteria under section 201 has, we believe, sent a clear signal that the escape clause remains a viable trade remedy.

This experience points up the second reason for the U.S. nonrubber footwear industry's four appearances before the ITC -- that is, our continued confidence in the mechanism of section 201. The escape clause provides a means, consistent with international law, by which import-injured industries can obtain a temporary respite when the reduction of trade barriers and other influences in the international trading environment put a domestic industry at a competitive disadvantage. We fully recognize, however, that this respite can only be temporary, and that a domestic industry receiving relief necessarily has a duty to use the import relief period to improve its competitive posture. Section 201 does not provide protection for protection's sake; Congress specifically viewed it as a means for promoting "adjustment" to new conditions of international competition.

The increasing extent to which many domestic industries have sought relief under section 201 in recent years has prompted some in Congress and the Administration to propose that the receipt of import relief under section 201 be conditioned upon the formulation of a detailed adjustment plan by the petitioning industry. FIA has no objection to such a "conditionality" principle, for whether or not a reasonable adjustment plan is a statutory precondition for the receipt of import relief, one can only expect that such a plan would be a crucial consideration in the President's decision to act favorably on an ITC recommendation of import relief. As a practical matter, an industry that has no plan of action for the import relief period is asking the President to impose certain costs on the U.S. economy with no real chance that the basic purpose of section 201 -- the adjustment to import competition -- will be accomplished. Thus, petitioning industries have a duty to devise and implement an adjustment plan that warrants the economic costs that import relief entails.

In recognition of this responsibility, FIA has formulated a five-year plan of action in connection with its ongoing section 201 case which it believes is among the most detailed and ambitious adjustment plans ever advanced by an industry in an escape clause proceeding. The U.S. nonrubber footwear industry recognizes that one of its prime objectives must be to achieve the highest possible level of technological competence and innovation in order to become more cost competitive with imports. An exhaustive study commissioned by FIA has demonstrated that full adoption of currently available state-of-the-art technologies will allow the industry to reduce its ex-factory prices by 11-14 percent, thereby substantially narrowing the cost gap. In light of these dramatic findings, the industry has already embarked on a major program designed to assure that currently available advanced technologies achieve optimal market penetration, while at the same time creating a framework to concentrate the industry's efforts in continued research and development in this area. But these efforts will only be successful if the President takes action truly designed to remedy the serious injury currently being experienced by the U.S. industry. Without an extended period of import restrictions to create a stable production base, U.S. manufacturers will not have the capital or the confidence to invest in new technology.

The industry's five-year plan of action in the area of technology -- a copy of which is enclosed herewith -- covers three phases. In Phase One of the plan -- which has already been completed -- the task was to survey the state of the art in footwear manufacturing and identify priorities and mechanisms to accelerate the development and application of advanced technology in the U.S. nonrubber footwear manufacturing industry. Equipped with this information, the industry will be able to embark on the second and third phases of the plan under a period of import relief. Phase Two calls for concerted action to develop broad industry-wide utilization of existing advanced technology, as identified in the already-completed survey. This will in large part involve close analysis of the operations of individual footwear producers and the development of individually-tailored plans for incorporating state-of-the-art technology into those manufacturing operations. Finally, under Phase Three of the plan, the goal will be to stimulate a comprehensive program for applying leading edge technology to the targeted priorities of the footwear industry in order to achieve major breakthroughs in the conversion of footwear manufacturing into a more capital-intensive enterprise.

Although FIA believes that cost savings obtained through the use of new technologies offer the most tangible promise for increasing the competitiveness of the U.S. nonrubber footwear industry, the importance of efforts to increase the marketing abilities of the industry are also appreciated. Accordingly, the industry's five-year plan of action also emphasizes the improvement of the industry's marketing efforts through improved product design, consumer research and education, sales management training, long-range corporate and marketing planning, new sales and marketing technologies and export trading assistance.

A lot of hard work went into the development of this five-year plan of action, and FIA is extremely proud of the results. FIA believes the five-year plan of action signals the U.S. nonrubber footwear industry's determination to survive and the seriousness with which it views its obligations under the statute. Whether or not similar undertakings are demanded of industries petitioning under section 201 in the future, FIA expects the President to pay considerable attention to FIA's five-year plan as the time nears for his decision in our pending case. We are confident that the President will find the plan impressive and will see the wisdom of granting relief under section 201 to industries that *look not for protection for protection's sake, but for a temporary respite during* which the industry can aggressively help itself to adjust to new conditions of international competition.

Thank you very much for the opportunity to present these views.

FIA

U.S. NONRUBBER FOOTWEAR INDUSTRY
FIVE YEAR
PLAN OF ACTION

Developed by Executives
of the U. S. Footwear Industry
under the Direction of
Footwear Industries of America

April 1985

FOOTWEAR INDUSTRIES OF AMERICA

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COMMITTEES OF THE U. S. FOOTWEAR INDUSTRY WHICH CONTRIBUTED TO THE DEVELOPMENT OF THE FIVE YEAR PLAN OF ACTION

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FIVE YEAR PLAN OF ACTION

Executive Summary

Executive Summary

Introduction

The U.S. nonrubber footwear industry recognizes that during a five year period of import relief, it must undertake aggressive efforts to achieve the highest possible level of technological development and marketing competence if it is to narrow the competitive gap enough to assure survival in the years to follow. Consequently, it has already embarked on a Five Year Action Plan which will be the key to accelerating the necessary developments. Given a five year period of meaningful import relief which provides a stable market place for domestic products, major capital investments in new technology and advanced marketing techniques and systems would be experienced.

The Action Plan concentrates heavily in two broad areas - technology and marketing. Industry Task Forces have been at work on the development of these plans.

Technology

A three-phase program has been underway for many months with phase one completed and phases two and three underway.

Phase One: Determine State-of-the-Art and Identify Major Industry Priorities for Technology Development.

With the help of financing provided by a Department of Commerce Trade Adjustment Assistance grant and the extensive cooperation of industry executives, this phase has now been completed. A clear identification of the current state-of-the-art on the 54 most important shoemaking functions has been determined together with the degree of penetration of this advanced technology. In addition, a priority has been established for the most needed technological developments in order to give clear targeting to those interested in addressing these priority needs.

In order to manage this process a New Technology Task Force (NTTF) has been established. This Task Force has already embarked on extensive efforts to educate the industry and suppliers of technology to the needs of the industry and to act as a catalyst in generating development activity. These activities will be highlighted under Phase Two and Phase Three discussions.

Phase Two: Develop Broad Utilization of Existing Advanced Technology.

The FIA New Technology Task Force has created a "Technology Evaluation" concept which, when fully implemented, will offer companies the opportunity to evaluate their currently used technology against state-of-the-art technology in order to pinpoint investment opportunity areas. With work which is now underway in the creation of appropriate investment criteria concepts, such opportunities will be evaluated in order to determine the most cost effective alternatives. From this a comprehensive capital investment scheme for the company being evaluated consistent with its financial resources will be developed.

Existing technology, if fully utilized, offers significant opportunity for reducing break-even selling prices of the U.S. products, thus improving domestic competitiveness. Given a stable investment environment, Phase Two will concentrate on bringing the industry up to the highest possible level of state-of-the-art technology utilization.

Phase Three: Stimulate a Comprehensive Program for Applying Leading Edge Technology to the Target Priorities of the Footwear Industry.

Major opportunities exist today for changing the entire face of shoemaking technology a few years in the future. A comprehensive plan of development has already been engineered by the New Technology Task Force and is presented in matrix form in later attachments. The driving force in this entire concept is the pervasive and revolutionary impact of the computer. Beginning with the application of the computer to the design and pattern grading functions there is an enormous explosion of opportunities which then become possible. The New Technology Task Force sees CAD - Computer Aided Design - as the hub of a wheel (ex. A) from which many spokes offshoot. These are the great opportunities of the future. They are within our grasp and offer major promises of improved productivity, increased material utilization, lower overhead, shortened lead time and superior quality.

Phase Three will be devoted to aggressive efforts to bring about extensive research and development on a new wave of advanced technologies to begin coming on stream in the late 1980's and the early 1990's. A review of the accompanying Phase Three matrix will give some insight as to what developments the NTTF envisions, how the development will be managed, what timetable is possible and what benefits might be expected.

Marketing

The Marketing Action Plan is designed to improve the basic marketing skills and techniques of the industry in a number of significant areas.

A. Product Design - Design and product development training for stylists and line builders utilizing advanced CAD systems. A targeted, consumer-oriented design program can provide the domestic industry competitive advantages in fashion timing, authenticity and efficiency of labor and material utilization.

B. Consumer Research and Education - An active program of consumer marketing and research training, information gathering, and consulting services will provide the industry with essential skills.

C. Sales Management Training - FIA, which already provides an annual skills development program for industry sales managers, will expand to full training so that it is current and effective for all elements of the industry.

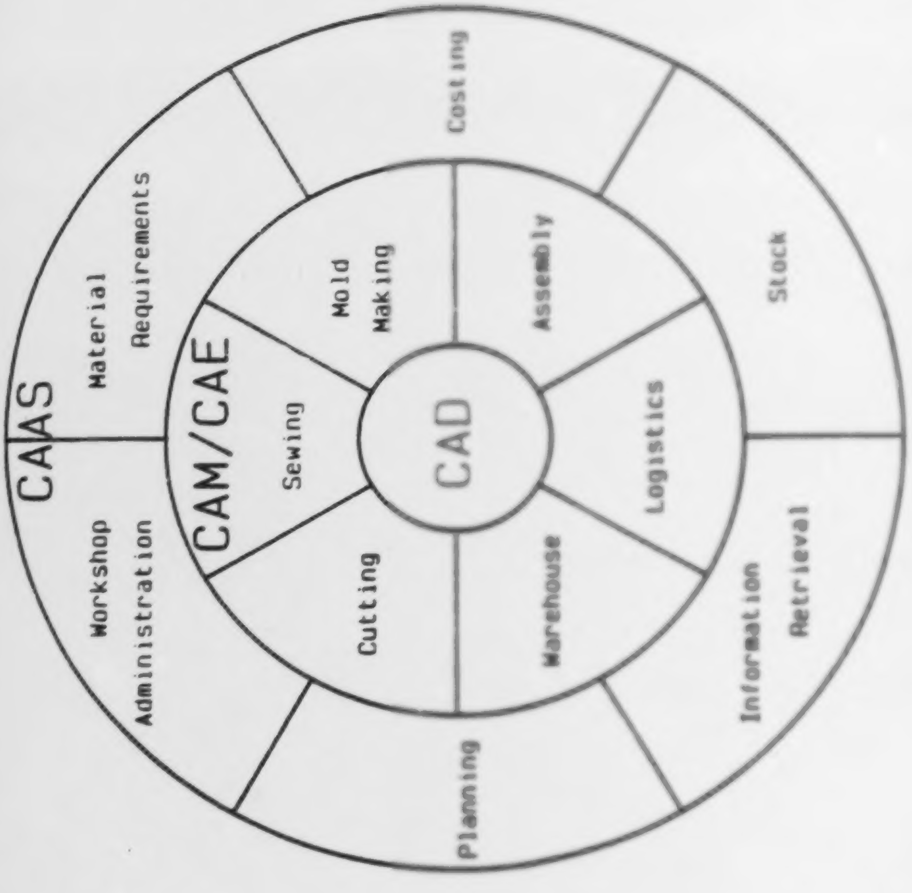
D. Strategic Planning at Corporate and Marketing Levels - Training and consultation services in the values and techniques of corporate/marketing planning will yield more consumer-focused activities.

E. State-of-the-Art Sales and Marketing Techniques - Many innovative new marketing techniques (catalogs, direct response, inside selling, telemarketing, etc.) will require accompanying new skills to maximize their effective use. FIA will offer a series of targeted seminars and training opportunities to domestic producers.

F. Export Trading Assistance - FIA will organize a centralized program for the industry which may include a non-competitive product consortium (trading company), education, training, and information - principally governmental - on oversees trade shows, all of which can make the domestic industry more competitive internationally.

G. Computer Software Specific to Footwear Industry - Many software programs are available to marketing management (research, product movement, financial databases, media, simulated test marketing, etc.). FIA will oversee development of universal marketing software specifically designed for the footwear industry. This can make such systems more cost-effective and efficient.

Exhibit A


CAAS
Workshop Administration
Material Requirements
Costing
Stock
Information Retrieval
Planning
CAM/CAE
Sewing
Mold Making
Assembly
Logistics
Warehouse
Cutting
CAD

FIVE YEAR PLAN OF ACTION

Technology

Technology

Phase One - Determine State-of-the-Art and Identify Major Industry Priorities for Technology Development.

1. Description

With the help of financing provided by a Department of Commerce Trade Adjustment Assistance grant and the extensive cooperation of industry executives, this phase has now been completed. A clear identification of the current state-of-the-art on the [illegible] most important shoemaking functions has been determined together with the degree of penetration of this advanced technology. In addition, a priority has been established for the most needed technological developments in order to give clear targeting to those interested in addressing these priority needs.

COMPLETED

In order to manage this process a New Technology Task Force (NTTF) has been established. This Task Force has already embarked on extensive efforts to educate the industry and suppliers of technology to the needs of the industry and to act as a catalyst in generating development activity. These activities will be highlighted under Phase Two and Phase Three discussions.

Technology

Phase Two - Broad Utilization of Available Advanced Technology

A. Technology Evaluations

1. Description and Rationale

The development of a program for evaluating the manufacturing firms within the industry and establishing their technology versus available advanced technology would seem to be a logical first step towards making greater penetration of currently available advanced shoe machinery and systems. The benchmark for comparative purposes would be the "Survey of the State-of-the-Art in Footwear Manufacturing and Identification of Priorities and Mechanisms to Accelerate the Development and Application of Advanced Technology in the U.S. Footwear Manufacturing Industry," technology study made recently in cooperation with FIA and the Department of Commerce. In order to carry out the evaluation process, outside consulting firms would be used to supplement FIA efforts in this area. In addition to the evaluation program, seminars on State-of-the-Art technology, and Investment Criteria will be given by geographic footwear region. In order to demonstrate the effectiveness of installing and utilizing the available advanced technology, a computer factory simulation, comparing a typical low technology penetration factory versus one containing the most advanced available technology would be made. This simulation effort would quantify the complete savings summary if full utilization of available advanced technology were made.

2. Development Responsibilities

Technology evaluations would be the primary responsibility of the FIA Technology Divison which would make use of outside consultants where appropriate.

3. Methodology/Management

Overall development in management will be the joint responsibility of FIA Technology Division's staff, the consulting firms utilized, and the FIA Technology Steering Committee, including the New Technology Task Force.

4. Methodology/Finance

FIA and its industry members would be expected to finance the major portion of the technology evaluations. Should a research grant be necessary for the proposal computer factory technology simulation, this would be obtained from government sources.

5. Timetable and Check Points

Within the next several months consulting firms could be contacted to supplement FIA's efforts in regard to the factory evaluations. Technology seminars are presently scheduled beginning in April, 1985. The computer factory technology simulation, assuming a research grant is forthcoming, could commence in early 1986 and be completed by the middle of 1987.

6. Industry Benefits

The industry at present has a very low degree of penetration of advanced technology. Assuming full penetration of advanced technology under current conditions, tremendous savings, including labor, material, quality, and timeliness can occur.

7. Benefits Quantification

It is estimated that in labor alone a 6 % reduction in the ex factory price can be realized; at least a 3 % reduction in ex factory price can be attributed to material savings and overhead of 4 % and 17 days reduced from the complete cycle time. This assumes an industry making full utilization of available advanced technology.

Technology - Phase Two

B. Financing Alternatives

1. Description and Rationale

Many financing alternatives are available for potential users of currently available advanced technology. These alternatives and their sources will be identified. One of the favored methods of information dissemination in this area is through the use of regional investor seminars, as well as regional TAAC seminars.

2. Development Responsibilities

It will be the direct responsibility of the FIA Staff, its Technology Division and Executive Staff to identify the options available for funding and financing. This would also apply to regional investor seminars where local banks, venture capitalists, and other potential funding sources would be invited to attend. FIA would work in close cooperation with the regional TAAC's on any seminars in their areas.

3. Methodology/Management

Overall development and program management will be the responsibility of the FIA Technology Division Executive, using the committee and task force chairmen as plan coordinators.

4. Methodology/Finance

All program elements will be borne financially by domestic industry companies. In some cases FIA may initially, during development phases, underwrite costs. For government assisted research programs, FIA would bear no out-of-pocket expenses, but would rely heavily on "in-kind" contributions of its member committees.

5. Timetable and Check Points

Most of the financing alternatives, identification of sources of financing, the establishment of regional investor seminars, etc., can all be initiated in 1985 and completed in 1986.

Technology - Phase Two

C. Training

1. Description and Rationale

One of the major concerns within the domestic manufacturing industry is training. Specifically, training focused on first line supervision, factory foremen, superintendents, and mechanics' in-house training. FIA, through its training division, presently has a successful supervisory skills training program ("SST") already in place; a stitcher instructor training program; a diagnostic and troubleshooting training program; and is proposing a middle management training program. At the outset of the American Shoe Center, training was an integral part of the establishment of this organization, as it was felt by the founders to be a top priority area and one in which the footwear industry was deficient. During the Technology Five Year Plan-of-Action we are proposing a continuation of the training programs presently in place plus extensions of these programs and complementary programs to coincide with the annual Footwear Technology Conference, the Shoe Tech Machinery Exhibition, as well as Pirmasens, the international machinery exhibition held every three years in Germany. In addition, FIA's Personnel Management Conference and regional technology symposiums will be scheduled during this 5-year period. As new concepts are developed, such as "ergonomics" and the training activity associated with OSHA's hazard communication regulation, they also will be addressed.

2. Development Responsibilities

All of the present and proposed training programs will be the responsibility of the FIA Training Task Force, in cooperation with FIA's Training Director, to initiate and carry out. In some instances, such as the regional technical seminars, the New Technology Task Force will interface with the Training Task Force.

3. Methodology/Management

Overall, development and program management will be the responsibility of FIA's Technology Division working directly with the Training Task Force and the training director.

4. Methodology/Finance

Any new programs in the area of training will be developed and financed by both FIA and interested industry executives. As in the case of SST, six companies plus FIA each put in pledged amounts, or shares, in order to get the initial program started. Once introduced to the industry the programs were charged on a fee basis, and that practice is expected to continue for any new programs in the training area.

5. Timetable and Check Points

Most of the training programs are already in place and expect to remain so for the next five years. These programs will be extended and modified as necessary to keep pace with changes as they occur. With the exception of Shoe Tech and Pirmasens, which occur every three years, the proposed regional conferences and technology conferences will be on an annual basis.

6. Industry Benefits

The most direct benefit to the industry in terms of supervisory skills training will be in attracting and maintaining knowledgeable first line managers throughout the industry. This has been one of the industry's most severe problems over the years, and as technology advances it will become even more critical to have supervisors with the necessary skills to deal with high technology.

Assuming full utilization of all available training is made, it is expected to have a potential overhead savings of at least 1 % off the ex factory price, with a material savings of at least 1 % off the ex factory price. Fully trained, competent managers will also have a beneficial effect on quality and cycle time.

5 YEAR PLAN OF ACTION—TECHNOLOGY
PHASE TWO—BROAD UTILIZATION OF AVAILABLE ADVANCED TECHNOLOGY

BASIC COMPONENTS	OBJECTIVE OF WORK	RESPONSIBILITY	MANAGEMENT	FINANCING	TIMETABLE[1]						BENEFITS[2]				
					85	86	87	88	89	90	MAT (%)	LAB (%)	O' HEAD (%)	QUALITY (±)	TIME (days)
TECHNOLOGY EVALUATIONS	To achieve state-of-the-art U.S. industry														
	Enlist and train consulting firms to supplement FIA efforts	FIA	FIA Staff	FIA & Industry	X										
	Promote evaluation program throughout the industry	FIA	FIA Staff	FIA & Industry	X	X									
	Conduct regional state-of-the-art seminars focused on plant departments, e.g., lasting, etc.	FIA	FIA Staff & Consulting Firms	FIA & Industry	X	X	X								
	Conduct investment criteria seminars	FIA	FIA Staff & Consulting Firms	FIA & Industry	X	X	X								
	Develop computer state-of-the-art plant simulation	FIA & Consultant	FIA Task Force	Research Grant		D	X	>	>	>					
Savings summary if full utilization of available technology											3.0	6.0	4.0	+	17.0
FINANCING ALTERNATIVES	Identification of historic and non-historic sources of financing	FIA	FIA Task Force	FIA & Industry	D										
	Regional potential investor seminars • Acquisition of new technology • Venture capital for R&D	FIA	FIA Task Force	FIA & Industry	X	X									
	Trade Adjustment Assistance Center (TAAC) seminars	TAAC's & FIA	FIA Task Force	FIA & Industry	X	>	>	>	>	>					

[1] D = Under Development
X = Operational
> = Ongoing Activity

[2] MAT = % savings in factory selling price
LAB = % savings in factory selling price
O' HEAD = % savings in factory selling price

QUALITY + = improvement in product quality
TIME = # of days reduction in cycle time for bringing a new product to market. Assumes current average cycle time for new product requiring new last, new patterns, new heels, etc. is 150 days from concept to delivery

5 YEAR PLAN OF ACTION—TECHNOLOGY

PHASE TWO—BROAD UTILIZATION OF AVAILABLE ADVANCED TECHNOLOGY *Continued*

BASIC COMPONENTS	OBJECTIVE OF WORK	RESPONSIBILITY	MANAGEMENT	FINANCING	TIMETABLE						BENEFITS				
					85	86	87	88	89	90	MAT (%)	LAB (%)	O' HEAD (%)	QUALITY (±)	TIME (days)
TRAINING	Supervisory Skills Training (SST)	FIA	FIA Staff	FIA & Industry	X	>	>	>	>	>				+	
	Stitcher Instructor	FIA	FIA Staff	FIA & Industry	X	>	>	>	>	>		1 0		+	
	Mechanic's Diagnostic and Trouble Shooting Skills	FIA	FIA Staff	FIA & Industry	X	>	>	>	>	>			1 0	+	
	Technology Conference	FIA & Industry Execs	FIA Task Force	FIA & Industry	X		X	X		X					
	Shoe Tech—tri-annual technology exposition	FIA & Industry Execs	FIA Task Force	FIA & Industry		X			X						
	Pirmasens/Simac/ SATRA tour	FIA	FIA Staff	FIA & Industry	X			X							
	Personnel Management Conference	FIA & Industry Execs	FIA Task Force	FIA & Industry	X	>	>	>	>	>					
	Regional focused technology symposiums	FIA & NTTF & Suppliers	FIA Task Force	FIA & Industry	X	>	>	>	>	>					
	Ergonomics regional seminars	FIA	FIA Task Force	FIA & Industry	X		X		X					+	

[1]D = Under Development
X = Operational
> = Ongoing Activity

[2]MAT = % savings in factory selling price
LAB = % savings in factory selling price
O' HEAD = % savings in factory selling price

QUALITY + = improvement in product quality
TIME = # of days reduction in cycle time for bringing a new product to market. Assumes current average cycle time for new product requiring new last, new patterns, new heels, etc. is 150 days from concept to delivery

Technology

Phase Three - Leading Edge Technology Development

A. CAD (Computer-Aided Design)

1. Description and Rationale

We have seen developments take place over the past 15 years in the 2D designing of patterns and pattern grading - all using the computer. In the past year or two, advancements have occurred in these areas, with 3D designing and solids modeling, graphics enchancements such as surface texturing, pattern grading from 3D - all are natural evolutions of today's technology. The core of all leading edge technology development within the footwear industry lies in this vital computer-aided design (CAD) area. (see Exhibit A).

2. Development Responsibilities

CAD's potential within the footwear industry has been principally in the hands of about six or seven commercial suppliers of available systems. It is the intention of FIA, along with its task force members, to work with these suppliers and help give the industry an understanding of the potential of CAD systems.

3. Methodology/Management

Overall development, management, and information dissemination lies in the realm of FIA to promulgate. As 3D last grading, graphics simulation, surfacing, etc. become more widely recognized as viable solutions, FIA and its task forces will most certainly play an important part.

4. Methodology/Finance

The use of complex graphics systems, 3D last grading, practical use of graphics systems, and the 3D grading of patterns from the last are all complex issues which require feasibility studies before their full potential is realized. For this reason a possible research grant from the government, with monies contributed by the industry, would be necessary.

5. Timetable and Check Points

2D design and pattern grading is already here. 3D design with solids modeling has started in earnest and by 1986 should be well developed. 3D last grading will probably commence as early as 1986 and have meaningful results by 1988; 3D pattern grading will undoubtedly be developed along with 3D last grading, and by 1988 we expect to see some new systems developed for this purpose.

6. Industry Benefits

Already some overhead benefit at the outset, where pattern engineers and model cutters are involved. Computer pattern grading certainly has already shown an improvement in quality and leadtime. As 3D pattern grading and last grading come into being a further reduction of 10 days from the lead time can be expected.

Technology - Phase Three

B. CAM (Computer-Aided Manufacturing)

1. Description and Rationale

The natural extension of computer-aided design is computer-aided manufacturing. The shoe geometry gathered and input during the pattern design stage of the shoe making process once captured can be used for a) last turning, b) mold making for heels, bottoms, wedges, insoles, and shanks, and c) die bending. In the factory operation, i.e. shoe assembly, this information can be used for tape and prom stitching, fancy stitching, functional stitching. The automatic cutting of leather would be a natural extension of CAD into CAM systems generated throughout the footwear industry.

In the lasting process we would probably start with microprocessor controlled lasting machines and progress into one machine lasting, and finally, move into some kind of robotics-assisted lasting procedures. In the bottoming area there is tremendous potential for computer-controlled roughing (already in existence), new breakthroughs in cement for sole attaching, automated outsole and insole preparation, and finally, robotics. In the finishing and packing areas automatic spraying through robotics is certainly a high potential. In the prefitting area such things as computer skiving, one-time cement reinforcement, and elimination of stitch marking, and finally, work transport and intelligent handling systems are a natural extension of any CAM system. Work cells are already in existence in a few factories within the footwear industry.

2. Development Responsibilities

Most of the CAM systems mentioned will be the responsibility of commercial suppliers to develop. In some instances, such as functional stitching, possibly leather cutting, and lasting, FIA and its New Technology Task Force would assist commercial suppliers in developing the most practical systems. Where necessary, FIA would assist supplier companies in organizing consortiums, joint ventures, and other methods for R & D work.

3. Methodology/Management

Where required, manufacturing task forces developed within FIA will work with suppliers and help guide in the development of the various factory computer-aided manufacturing operations.

4. Methodology/Finance

Certain programs, such as last turning, mold making, die bending, etc. will require no assistance in financing as it will be handled by the individual suppliers involved. In other instances, such as functional stitching and automatic leather cutting, there is the possibility of cooperative research and government grants. These will be developed on a case by case evaluation.

5 Timetable and Check Points

CAM last turning is possible as early as 1986; mold making is available now and can be much improved by 1986; automatic die bending is conceptually available now and could be completely developed by the end of 1986; functional stitching and true 3D stitching will probably not be possible until 1988; sequencing won't occur until 1989; automatic leather cutting is possible at almost anytime, and if started in 1986 could be completed in 1987. Other CAM possibilities, including lasting, bottoming, automatic spraying are likely between 1986 and 1988. Robotics in most of the areas will not be available until 1988, 1989 and 1990.

6. Industry Benefits

Last turning by computer-aided manufacturing techniques will speed up the process of introducing a new last by the manufacturer by approximately five days; mold making - ten days; automatic die bending - three days taken out of the cycle time. Lead times and the possibility for reducing them in this area have a great advantage over foreign competitors and the potential for drastically reducing these lead times lies in this area: i.e. the introduction of new lasts, molds, and dies. Percentagewise, the expected labor savings on prom stitching, decorative stitching, new methods of 2D and 3D stitching would be approximately 2 %, 1 %, 3 %, 3 % respectively, all off the ex factory price. In leather cutting we would estimate a 1 % labor saving and a 5 % material gain. In the lasting area the complete one machine lasting system would probably reduce labor by 2 %, and in the bottoming areas computer roughing would further reduce the labor content by 1 %. The possibility of such improvements as a new sole attacning cement, automated sole preparation, and automated spring computer skiving would all have less than 1 % anticipated savings in labor.

Technology - Phase Three

C. CAE (Computer-Aided Engineering)

1. Description and Rationale

A further extension of any integrated CAD system would be computer-aided engineering systems, including costing, labor standards, and material standards. Attempts have been made for several years to "piecemeal" such standards and in most instances these systems are not fully integrated with in-house main frame computer systems. Under a fully integrated CAD system, basic information originally stored for pattern design can be used for most CAE systems.

2. Development Responsibilities

The development of these systems would probably be initiated by a Systems Task Force already in place under FIA's Footwear Technology Conference Committee.

3. Methodology/Management

Overall development and management of the proposed CAE systems would be the responsibility of FIA's Technology Division along with the Systems Development Task Force.

4. Methodology/Finance

Any funding necessary to start the initial program development will be underwritten by FIA and its industry members.

5. Timetable and Check Points

The initial groundwork for labor and material standards stemming from any integrated CAD system could start as early as 1985. A complete system concept would depend on the length of time necessary to complete the CAD and CAM phases outlined in Paragraphs A and B.

6. Industry Benefits

Under current systems, even those that are fully automated and computerized, there is a tremendous waste in labor and effort organizing information, even though it could very well have been captured during the pattern design phase. Once fully integrated, this overlapping of information gathering could be eliminated.

7. Benefits Quantification

We estimate that at least two days of the initial "upfront" development time of new styles could be eliminated by a fully integrated computer-assisted engineering system.

Technology - Phase Three

D. CAAS (Computer-Aided Administrative Systems)

1. Description and Rationale

As in computer-aided engineering systems, administrative systems for the footwear industry having computer applications which could be fully integrated with the previously mentioned CAD system include: materials' requirements planning MRP; (computer explosion of these requirements) order entry, invoicing, finished goods, production tags, raw materials, accounts receivable, work in process, purchase orders, piecework payroll, accounts payable, cutting analysis. All of these "systems" are a natural extension of a complete CAD system into a CAAS, as this information is captured originally during the pattern design stage. Further down the line is plant layout, including computer graphics for the automated factory, shopfloor control, and others.

2. Development Responsibilities

The development of each of these systems would be accomplished by FIA and its task forces. The Systems Task Force would play a major role in this area.

3. Methodology/Management

The overall development and management of the systems area will be the direct responsibility of the FIA Technology Division. Here, again, major contribution would be made by industry executives and companies employing one or more of these systems.

4. Methodology/Finance

Most of the program development will be carried out by FIA Task Forces already in place, and no anticipated financing is required other than the in-kind contribution presently being given by industry members. In certain instances, such as the investigation of multi-shift operations, an in-depth study requiring a research grant might be feasibile.

5. Timetable and Check Points

Much of the groundwork for establishing the proposed CAAS information is already available. During 1985 most of the preliminary work will be started, and it should be completed by late 1986.

6. Industry Benefits

Many of the proposed systems are very difficult to quantify since there are so many "soft" benefits involved. For certain of these systems already in place and available commercially, savings in materials, labor, and lead times can be quite significant. With an effective MRP system, for example, reduction in obsolete materials resulting from effective use of such systems can be enormous. Obsolete upper materials in the mens' and womens' fashion leather footwear business is a primary cost of doing business. Any reduction in seasonal obsolescence in this area, even as low as one percent can mean tremendous savings to these companies.

Technology - Phase Three

E. Quality Management

1. Description and Rationale

The introduction of statistical quality control to the footwear industry by comprehensive quality management techniques will become of primary importance during the next five years. As high tech systems and equipment penetrate the footwear industry, the control of quality becomes even more critical. Unlike the domestic automobile industry, where quality has deteriorated when compared to Japanese imports, American footwear is perceived to the domestic consumer as being the highest in the world. It is essential during our five-year technology plan that we include a proposal to maintain these high standards.

2. Development Responsibilities

The FIA Technology Division will develop the program format with the help of industry executives.

3. Methodology/Management

A special FIA Task Force for quality management will be organized, to include a quality management consultant, a professional in the field assigned to the task force.

4. Methodology/Finance

FIA and the industry would share the cost of this program. It is also possible that a special grant should be considered.

5. Timetable and Check Points

An industry survey and report to the task force would require four to six months. Identification of a consultant, funds generation, and initiation of the project could start in early 1986 and be fully operational by the first six months of 1988.

6. Industry Benefits

The most obvious and immediate benefit for improved quality would be in lessening the competitive gap between imports and domestic high quality shoes. Seasoned United States buyers throughout the Far East see a rapid improvement in the quality of shoes coming out of countries such as Korea. Setting the cost advantages aside, as import quality improves, it is even more essential that domestic shoes continue to have a high quality image with the domestic consumer.

7. Benefits Quantification

Improved quality does not mean increased labor costs; on the contrary, improved quality leads to improved efficiencies with corresponding labor savings of at least one percent, and material savings of at least two percent, from the ex factory price.

Technology - Phase Three

F. Human Resource Management

1. Description and Rationale

To develop programs and techniques for attracting qualified managers to the footwear industry. The Human Resource Management Program would have five primary areas of concentration: 1) acquisition, 2) training, 3) motivation, 4) labor relations, 5) ergonomics.

2. Development Responsibilities

Each of the program formats will be developed by FIA's Technology Division, in cooperation with industry executives and the FIA Training Task Force.

3. Methodology/Management

Overall development and management will be the responsibility of the FIA Technology Division using the Training Director as liaison. In the field of labor relations, we would hope to create innovative concepts for labor/management relations with the cooperation of FIA Staff and industry.

4. Methodology/Finance

In each of the four areas of human resource management FIA and the industry will share the cost of financing, with the exception of the labor relations area, where the unions will be asked to contribute towards the project.

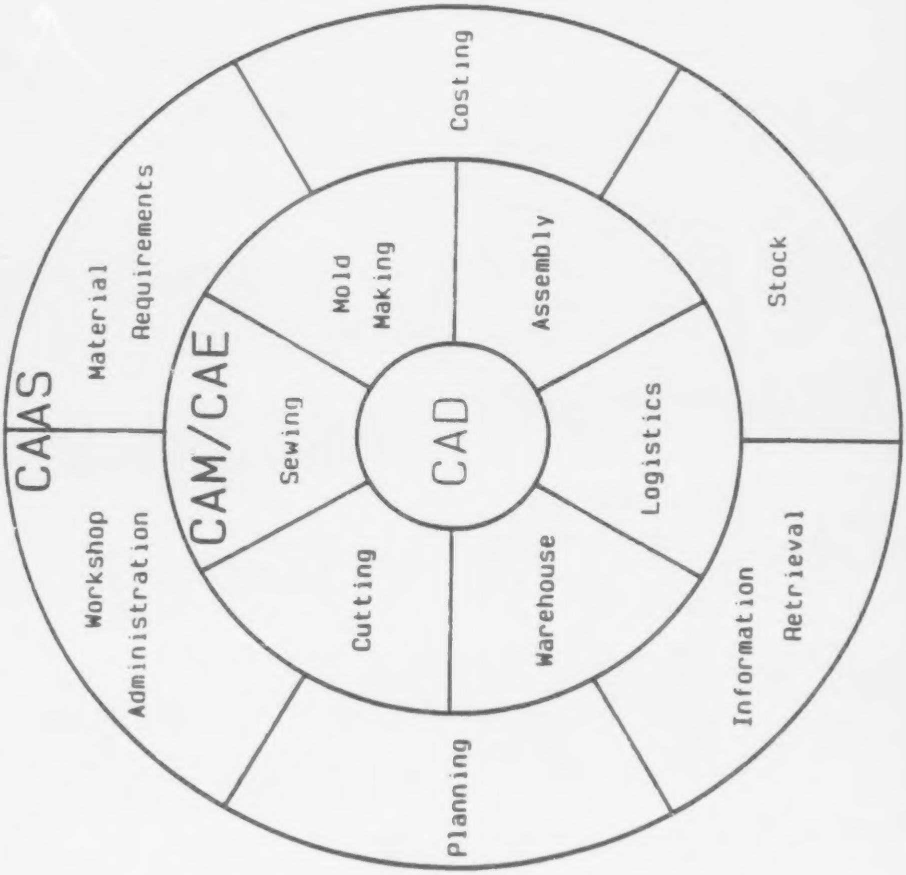
5. Timetable and Check Points

All of the programs involving human resource management will be developed during 1985, 1986. Certain programs will take precedence over others as there will be a natural transition from one type of training into other types (first line management - middle management - strategic management).

6. Industry Benefits and Benefits Quantification

Although not specifically quantifiable, the benefits to the industry in this area are considered to be in the area of "soft" or intangible benefits. They are, however, extremely important areas, and in the case of programs already in place, such as SST, written testimonials from users of this program prove its worthiness to the industry. In the area of labor relations the role of the labor unions working in cooperation with FIA and industry executives will be an essential ingredient to any five year plan of recovery.

Exhibit A


CAD
CAM/CAE
CAAS
Sewing
Mold Making
Assembly
Logistics
Warehouse
Cutting
Material Requirements
Costing
Stock
Information Retrieval
Planning
Workshop Administration

5 YEAR PLAN OF ACTION—TECHNOLOGY
PHASE THREE—LEADING EDGE TECHNOLOGY DEVELOPMENT

BASIC COMPONENTS	OBJECTIVE OF WORK	RESPONSIBILITY	MANAGEMENT	FINANCING	TIMETABLE						BENEFITS				
					85	86	87	88	89	90	MAT (%)	LAB (%)	O HEAD (%)	QUALITY (+)	TIME (days)
CAD—COMPUTER AIDED DESIGN	Full utilization of computer in design process														
	2D design and pattern grading	Now Commercial	FIA Promulgate	None	X	>	>	>	>	>					17.0*
	3D design with solids modeling	Now Commercial	FIA Promulgate	None	X	>	>	>	>	>				+	10.0*
	3D last grading	FIA with Suppliers	Consider joint venture with FIA as catalyst	Research Grant & Industry	D	D	X	>	>	>					10.0
	Graphics enhancement—surface texturing	FIA with Suppliers	Consider joint venture with FIA as catalyst	Research Grant & Industry	D	D	X	>	>	>					5.0
	Pattern grading from 3D	FIA with Suppliers	Consider joint venture with FIA as catalyst	Research Grant & Industry	D	D	X	>	>	>			2.0		2.0
CAM—COMPUTER AIDED MANUFACTURING **Components**															
	Last turning	Commercial Suppliers	Not Required	None	D	X	>	>	>	>	1			+	5.0
	Mold making—heels, bottoms, insoles, shanks	Commercial Suppliers	Not Required	None	D	X	>	>	>	>	1			+	10.0
	Cutting die bending	Commercial Suppliers	Not Required	None	D	X	>	>	>	>				+	3.0
Shoemaking	Tape & prom stitching	Commercial Suppliers	Not Required		X/D	X/D	X	>	>	>	2.0 (2.0)	1.0			
	Decorative stitching	Commercial Suppliers	Not Required		X/D	X/D	X	>	>	>	1.0 (1.0)				

* = ( ) = considered in phase two

D = Under Development
X = Operational
> = Ongoing Activity

MAT = % Savings in factory selling price
LAB = % Savings in factory selling price
O' HEAD = % Savings in factory selling price

QUALITY + = improvement in product quality
TIME = # of days reduction in cycle time for bringing a new product to market. A [illegible] cycle time for new product requiring new last, new patterns, new heels, etc. is 150 days from receipt to delivery.

5 YEAR PLAN OF ACTION—TECHNOLOGY
PHASE THREE—LEADING EDGE TECHNOLOGY DEVELOPMENT *Continued*

BASIC COMPONENTS	OBJECTIVE OF WORK	RESPONSIBILITY	MANAGEMENT	FINANCING	TIMETABLE¹						BENEFITS				
					85	86	87	88	89	90	MAT (%)	LAB (%)	O HEAD (%)	QUALITY (+)	TIME
Shoemaking *continued*	Functional stitching	FIA with Commercial Suppliers	Task force of manufacturers to work with suppliers to guide development	Co-op Research and/or Research Grant											
	Stage 1 (2D)—joining parts—flat				D	X	>	>	>	>	1.0	3.0	1.0	+	
	—Close edge stitching				D	D	X	>	>	>				+	
	—Back seam				D	X	>	>	>	>				+	
	—Tangential stitching				D	D	D	X	>	>				+	
	—Stitch and trim						D	D	D	X				+	
	Stage 2 (3D)—Joining of parts				D	D	D	X	>	>		3.0	1.0	+	
	—Close edge stitching				D	D	D	X	>	>				+	
	—Back seam				D	D	X	>	>	>				+	
	—Tangential stitching						D	D	X	>				+	
	—Stitch and trim							D	D	D				+	
	Stage 3 —Sequencing or automatic work movement between jobs					D	D	D	X	>		2.0	1.0		
	Cutting of manmade materials	FIA with Suppliers	FIA Task Force consider joint venture with FIA as catalyst	None	D	X	>	>	>	>	3.0				1.0
	Cutting of leather	FIA with Suppliers	FIA Task Force consider joint venture with FIA as catalyst	Co-op Research and/or Research Grant		D	D	D	X	-	3.0				1.0

¹D – Under Development
X = Operational
> = Ongoing Activity

MAT = % savings in factory selling price
LAB = % savings in factory selling price
O'HD = % savings in factory selling price

QUALITY + = improvement in product quality
TIME = # of days reduction in cycle time for bringing a new product to market. Assumes current average cycle time for new product requiring new last, new patterns, new tools, etc. is [illegible] days from concept to delivery

5 YEAR PLAN OF ACTION—TECHNOLOGY
PHASE THREE—LEADING EDGE TECHNOLOGY DEVELOPMENT *Continued*

BASIC COMPONENTS	OBJECTIVE OF WORK	RESPONSIBILITY	MANAGEMENT	FINANCING	TIMETABLE						BENEFITS				
					85	86	87	88	89	90	MAT (%)	LAB (%)	O'HEAD (%)	QUALITY (±)	TIME (days)
Shoemaking *continued*	Lasting Stage 1 —Micro-processor control	Commercial Suppliers	Not Required	None	X	>	>	>	>	>		20	10		
	—"One machine" lasting	FIA with Suppliers	FIA Task Force	None	D	D	D	X	>	>					
	—Robotics				D	D	D	D	D	D					
	Bottoming —Computer controlled roughing	Commercial Suppliers	FIA Task Force to coordinate if suppliers desire	None	D	X	>	>	>	>		10		+	
	—Cement break-through	Commercial Suppliers	FIA Task Force to coordinate if suppliers desire	None	D	D	D	X	>	>	20	5	2	+	
	—Automated sole preparation	Commercial Suppliers	FIA Task Force to coordinate if suppliers desire	None	D	X	>	>	>	>		5	2		
	—Robotics	Commercial Suppliers	FIA Task Force to coordinate if suppliers desire	None	D	D	D	X	>	>					
	Finish/Pack —Automatic spraying	Commercial Suppliers	FIA Task Force to coordinate if suppliers desire	None		D	D	D	X	>		5	2	+	
	Pre-fit —Computer skive	Commercial Suppliers	FIA Task Force to coordinate if suppliers desire	None	D	D	D	X	>	>		2	1	+	
	—"One time" reinforce	Commercial Suppliers	FIA Task Force to coordinate if suppliers desire	None	D	X	>	>	>	>		20	10	+	
	—Automatic stitch mark	Commercial Suppliers	FIA Task Force to coordinate if suppliers desire	None	D	D	D	X	>	>		5	2	+	5

D - Under Development
X - Operational
> = Ongoing Activity

MAT = % savings in factory selling price
LAB = % savings in factory selling price
O'HEAD = % savings in factory selling price

QUALITY + = improvement in product quality
TIME = # of days reduction in cycle time for bringing a new product to market. Assumes current average cycle time for new product requiring new last, new patterns, new heels, etc. is [illegible] days from concept to delivery

5 YEAR PLAN OF ACTION—TECHNOLOGY
PHASE THREE—LEADING EDGE TECHNOLOGY DEVELOPMENT *Continued*

BASIC COMPONENTS	OBJECTIVE OF WORK	RESPONSIBILITY	MANAGEMENT	FINANCING	TIMETABLE						BENEFITS				
					85	86	87	88	89	90	MAT (%)	LAB (%)	O'HEAD (%)	QUALITY (+)	TIME (days)
Shoemaking *continued*	Work Handling Systems —Work cells	Commercial Suppliers	FIA Task Force to coordinate if suppliers desire	None	D	D	D	D	D	D					
	—Prefit and fitting	Commercial Suppliers	FIA Task Force to coordinate if suppliers desire	None											
	—Lasting	Commercial Suppliers	FIA Task Force to coordinate if suppliers desire												
	—Bottoming	Commerical Suppliers	FIA Task Force to coordinate if suppliers desire												
CAE— COMPUTER AIDED ENGINEERING	Generic software programs for footwear industry														
Costing Labor Standards	Computer created labor standards plus explosion of standard hours	Now Commercial	Identify and promote use of currently available systems	FIA	X	>	>	>	>	>		10	10		10
Material Standards	Computer created material standards plus explosion of material requirements	Now Commercial	Identify and promote use of currently available systems	FIA	X	>	>	>	>	>			10		10
Plant Management Plant Layout	Computer graphics spin off from labor and machine requirements data base	FIA with Commercial Suppliers	FIA Task Force	FIA & Industry	D	D	X	>	>	>					
Shop Floor Control	Real time management of production flow, job manning, etc.	Now Commercial	FIA Promulgate	FIA	X	>	>	>	>	>					
Multi-Shift Operations	Make in-depth study of barriers to multi-shift operation and devise solutions	FIA	FIA Task Force & Consultant	Research Grant or Industry	D	D	X	>	>	>					20

[1]D = Under Development
X = Operational
> = Ongoing Activity

[2]MAT = % savings in factory selling price
LAB = % savings in factory selling price
O'HEAD = % savings in factory selling price

QUALITY + = improvement in product quality
TIME = # of days reduction in cycle time for bringing a new product to market. Assumes current average cycle time for new product requiring new last, new patterns, new heels, etc. is 150 days from concept to delivery

5 YEAR PLAN OF ACTION—TECHNOLOGY
PHASE THREE—LEADING EDGE TECHNOLOGY DEVELOPMENT *Continued*

BASIC COMPONENTS	OBJECTIVE OF WORK	RESPONSIBILITY	MANAGEMENT	FINANCING	TIMETABLE						BENEFITS				
					85	86	87	88	89	90	MAT (%)	LAB (%)	O'HEAD (%)	QUALITY (±)	TIME (days)
CAAS— **COMPUTER AIDED ADMINISTRATIVE SYSTEMS**	Generic software and hardware programs for footwear industry														
MRP— **Manufacturing Requirements Planning** Materials Labor Machinery Lasts	Computer explosion of requirements	Now Commercial Systems Available	FIA Promulgate	FIA	X	>	>	>	>	>	10		10		10
Leading to creation of generic "just in time" system for footwear manufacturing															
Inventory Management Raw Materials In-Process Finished Goods Automatic Replenishment	Generic system to tie in with MRP system thus creating "just-in-time" inventory management from raw material to retail store	FIA & Industry Executives	FIA Task Force	FIA & Industry	D	D	X	>	>	>	10				
QUALITY MANAGEMENT	Application of modern quality control and management techniques to a generic footwear quality management system	FIA & Industry Executives	FIA Task Force	FIA & Industry	D	D	X	>	>	>	20	10		+	

D – Under Development
X = Operational
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MAT – % savings in factory selling price
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O'HEAD – % savings in factory selling price

QUALITY + – improvement in product quality
TIME – # of days reduction in cycle time for bringing a new product to market. Assumes current average cycle time for new product requiring new last, new patterns, new heads, etc. is 150 days from concept to delivery

5 YEAR PLAN OF ACTION—TECHNOLOGY
PHASE THREE—LEADING EDGE TECHNOLOGY DEVELOPMENT *Continued*

BASIC COMPONENTS	OBJECTIVE OF WORK	RESPONSIBILITY	MANAGEMENT	FINANCING	TIMETABLE						BENEFITS				
					85	86	87	88	89	90	MAT (%)	LAB (%)	O' HEAD (%)	QUALITY (+)	TIME (days)
HUMAN RESOURCE MANAGEMENT **Acquisition**	Develop programs and techniques to attract high potential managers to footwear industry	FIA & Industry Executives	FIA Task Force with Consultant	FIA & Industry	D	D	X	>	>	>	+	+	+	+	
Training	Develop industry specific management training at three levels	FIA & Industry Executives		FIA & Industry											
	(1) First line management		Already available		X	>	>	>	>	>	+	+	+	+	+
	(2) Middle management		Under Development		D	X	>	>	>	>	+	+	+	+	+
	(3) Strategic management		FIA Task Force with Business School Consultant		D	D	X	>	>	>	+	+	+	+	+
Motivation	Develop industry emphasis on employee motivation to achieve maximum productivity, superior product quality, innovative problem solving, minimum operating overhead	FIA & Industry Executives	FIA Task Force	FIA & Industry	D	D	X	>	>	>	+	+	+	+	+
Labor Relations	Create innovative concepts for labor/management cooperation in the development and application of new technologies	FIA, Industry & Unions	FIA & Union Task Force	FIA, Industry & Unions	D	D	X	>	>	>	+	+	+	+	+
Ergonomics	Develop industry awareness of potential for productivity and quality enhancement from applying this science. Special emphasis on applications to new technology under development.	FIA	FIA Staff—maybe later a task force	FIA	D	X	>	>	>	>		1.0		+	

D = Under Development
X = Operational
> = Ongoing Activity

MAT = % savings in factory selling price
LAB = % savings in factory selling price
O' HEAD = % savings in factory selling price

QUALITY = + improvement in product quality
TIME = # of days reduction in cycle time for bringing a new product to market. Assumes current average cycle time for new product requiring new last, new patterns, new heels, etc. is 150 days from concept to delivery

FIVE YEAR PLAN OF ACTION

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Marketing

FOOTWEAR INDUSTRIES OF AMERICA

Five Year Plan of Action - Marketing

Introduction: The U. S. footwear industry has addressed the need to enhance professional capabilities in all facets of marketing in order to succeed in the highly competitive and rapidly changing footwear market. It has initiated several programs and has planned other activities to help achieve this overall goal, but its ultimate positive effect will depend to a large extent on the enactment of a five year period of import relief, during which time such activities can commence in a stable production and time period.

To achieve these goals, a seven part activity plan has been developed:

A. Product Design - Design and materials specification training for stylists and line builders. A targeted, consumer-oriented design program can provide the domestic industry competitive advantages in fashion timing and sensitivity and technical ability.

B. Consumer Research and Education - An active program of consumer marketing and research training, information gathering, and consulting services will provide the industry with essential skills. FIA has initiated activity in instruction of research methods, an overall annual marketing seminar, and provision of purchase data from a consumer panel service. Consumer research has been completed and will be renewed under U. S. government grant.

C. Sales Management Training - The increasing complexity of the sales management function within footwear-related companies requires on-the-job and total coverage classroom training. FIA, which already provides an annual skills development program for industry sales managers, will expand to full training so that it is current and effective for all elements of the industry.

D. Strategic Planning at Corporate and Marketing Levels - Many domestic footwear companies have, historically, been sales or manufacturing centered. Training and consultation services in the values and techniques of corporate/marketing planning will help streamline their operations and yield more consumer-focused activities.

E. State-of-the-Art Sales and Marketing Techniques - Many innovative new marketing techniques (catalogs, direct response, inside selling, telemarketing, etc.) will require accompanying new skills to maximize their effective use. FIA will offer a series of targeted seminars and training opportunities to domestic producers.

F. Export Trading Assistance - FIA will organize a centralized program for the industry which may include a non-competitive product consortium (trading company), education, training, and information - principally governmental - on oversees trade shows, all of which can make the domestic industry more competitive internationally.

G. Computer Software Specific to Footwear Industry - Many software programs are available to marketing management (research, product movement, financial databases, media, simulated test marketing, etc.). FIA will oversee development of universal marketing software specifically designed for the footwear industry. This can make such systems more cost-effective and efficient.

Marketing

A. Product Design

1. Description and Rationale

Product design and materials specification training (for sample development) for stylists and line builders, to make them more time responsive to market fashion trends. This would include technical training in consumer fashion (trends, color direction, materials). Although available in Europe and on a partial basis in the U.S. (such as at F.I.T. and Parsons) no complete marketing/technical design training program specifically for the industry has been available.

2. Development Responsibilities

Program format will be jointly developed by FIA Marketing and Technology Training Task Forces, FIA Training Director, and Marketing and Technology Division executives.

3. Methodology/Management

Overall development and management will be the joint responsibility of FIA Marketing and Technology Division executives. It is anticipated that program content will be accomplished by a combination of FIA Training, outside design consultants, and academic institutions or professional training consultants, with guidance from FIA committees.

4. Methodology/Finance

Initial program development will be underwritten by domestic footwear manufacturers (those with stylists and line builders who could use training) on a subscription basis, with costs to be shared equally.

5. Timetable and Check Points

Program concept will be developed within six to eight months.

*Pilot program (base modules) will be funded and developed over the next nine to twelve months.

*Initial training will take place from eighteen to twenty-one months from start point. At twenty-one to twenty-four months, the product design program will be fully operational with modules being added as required.

6. Industry Benefits

The domestic industry has historically relied on its own members, academic institutions, European design firms, other industries, etc. to train footwear stylists and line builders. A targeted, consumer-oriented design training program will potentially provide the industry a competitive advantage in terms of fashion timing, sensitivity, and technical ability.

7. Benefits Quantification

Reduction in sample development time in response to market trends. Improvement in design quality/professionalism. Precise time saving will be estimated prior to training, quantified after training (relative to pre-training experience).

Marketing

B. Consumer Research & Education

1 Description and Rationale

A single resource and system for consumer research training, information and consulting services for both manufacturers and suppliers, targeted particularly at small to medium-sized companies. Ongoing knowledge of consumer attitudes and purchase influences are keys to a more competitive marketing position for the domestic industry. This has begun with FOOT/TRACK* consumer footwear purchase data base and marketing research training seminars sponsored by FIA, and ongoing execution and use of consumer research to educate the public on values of domestically-produced footwear. Included in consumer research will be government funded programs to identify consumer purchase factors. The above programs were all operative in 1984, and it is intended that they be continued.

2. Development Responsibilities

Program will be jointly developed by FIA's Marketing Steering Committee, Marketing Research and Analysis Task Force, Marketing Training Task Force, and Training Director.

3. Methodology/Management

Overall development and program management will be the responsiblity of the FIA Marketing Division executive, utilizing the Committee and Task Force chairmen as plan coordinators.

4. Methodology/Finance

All program elements will be borne financially by domestic industry companies. In some cases, however, FIA may initially (during development phases) underwrite costs. For government-assisted research programs, FIA would bear no out-of-pocket expenses.

5. Timetable and Check Points

Program concept will be generated within six months. From that point onward, each element will be executed sequentially. For example, marketing research and consumer product testing training can be developed and offered within a year. Targeted programs of consumer product education, possibly working in conjunction with retailers, will also be developed within a year. Timing of government-aided projects must be viewed independently.

*Copyright

6. Industry Benefits

Trade associations of other consumer product and service industries have assertively developed a coordinated program of consumer marketing and research training and information gathering. These skills are recognized as an essential ingredient in developing any company's or industry's competitive plan. Large companies and some mid-sized and smaller companies in the industry have invested in such information and in acquiring capabilities; however, they may be overlooked or avoided by other companies. Practical training and exposure will improve the professional level and competitive posture of the domestic industry. Information developed through government-assisted programs can also be used to educate consumers and support domestic producers.

7. Benefits Quantification

Most elements not strictly quantifiable. Opportunities for marketing research cost savings, following training, on a project by project basis within individual companies.

Marketing

C. Sales Management Training

1. Description and Rationale

Sales management is a multi-faceted profession of increasing complexity in the footwear industry, requiring not only on-the-job but total coverage classroom training in functions and responsibilities. FIA now offers an annual seminar of sales management skills training and will offer programs of training for field sales management and national/general sales management and larger companies in the industry have invested in sales training. Targeted, industry-specific full training has not been previously offered to domestic footwear manufacturers and suppliers.

2. Development Responsibilities

Program format(s) will be developed by FIA Marketing Training Task Force, Sales Management Committee, Training Director, and Marketing Division executive.

3. Methodology/Management

Overall development and management will be the responsibility of FIA Marketing Division executive using Training Director as liaison. It is anticipated that program content will be defined by industry and will be accomplished by FIA Training and outside professional sales management training consultant (similar to FIA's Supervisory Skills Training Program for first-line manufacturing supervisors).

4. Methodology/Finance

Initial program development will be underwritten by domestic manufacturers/ suppliers on a subscription basis, or by direct registration fees.

5. Timetable and Check Points

Industry survey and report to identify training modules will require four to six months. Identification of consultant, funds generation, and initial module development will be approximately six to nine months from survey completion. Full program available to industry within twelve to fifteen months of survey completion.

6. Industry Benefits

Sales representatives in the footwear industry have available a complete professional training program in all aspects of selling--from setting goals to behavior management, and follow-up. This training is provided through National Shoe Travelers Association (NSTA), an allied industry trade association representing footwear field salesmen. Sales management skills, equally, can be professionalized for the industry, making domestic marketing efforts more successful. Finally, a dual approach of field management and general management will integrate people, marketing, and planning skill requirements.

7. Benefits Quantification

Most elements not strictly quantifiable. Elements lending themselves to quantification (post training) include: measurable reduction in selling costs/expenses, reduction in employee turnover.

Marketing

D. Strategic Planning at Corporate and Marketing Levels

1. Description and Rationale

FIA will offer training and consulting services in the values and techniques of corporate/marketing planning. Historically, many domestic footwear industry companies have been sales or manufacturing-centered. A true consumer or marketplace resource focus requires coordinated corporate and marketing plans. Consultation services may include a corporate/marketing planning audit for domestic producers, including approaches for setting up new business development programs, and a clearinghouse for consulting resources.

2. Development Responsibilities

Basic program development will be the responsibility of FIA Marketing Division executive and Marketing Steering Committee. Marketing Planning Task Force (reporting to Marketing Steering Committee) may be established. Targeted training audit approaches may be developed in conjunction with an outside professional.

3. Methodology/Management

FIA's Marketing Division executive will act as program coordinator. Outside professional or academic consultant may serve as liaison.

4. Methodology/Finance

All programs will be funded by industry members. Audit fee structure would be established to cover each business aspect.

5. Timetable and Check Points

Basic program planning will be undertaken immediately by the Marketing Steering Committee. Task Force will be formed and meet within three months. Outside consultant will be retained and targeted seminar programs offered within twelve months. Pilot planning audit program will be offered within six months of Task Force formation.

6. Industry Benefits

Moving toward greater corporate productivity and innovation, decision-making dynamism, and market orientation is difficult for any company, whatever the industry. Provision of training in long range planning and consulting support for domestic footwear companies will help streamline their operations and yield more consumer-focused activities. This will particularly benefit smaller, family directed organizations within the industry.

7. Benefits Quantification

Most elements not strictly quantifiable. If corporate/marketing planning audits are instituted, these could yield measurable improvements on a company by company basis.

Marketing

E. State-of-the-Art Sales and Marketing Techniques

1. Description and Rationale

FIA will offer a series of targeted seminars and training opportunities for domestic producers on available new sales and marketing technologies such as catalogs, direct response, inside selling, telemarketing, computer linking to retailers (automatic reorder/replenishment system). Company by company consulting services may also be offered.

2. Development Responsibilities

Development will be the responsibility of FIA Marketing Division executive, Training Director, Marketing Steering Committee and Marketing Training Task Force.

3. Methodology/Management

Overall development and management will be the responsiblity of FIA Marketing Division executive using Training Director as support. It is anticipated that one or more specialized outside consultant(s) will be involved.

4. Methodology/Finance

All program elements and/or consulting activity will be directly funded by industry members. This will be done either by seminar/training program registration fees or direct consultant payment.

5. Timetable and Check Points

Once identified by FIA Marketing Steering Committee and Marketing Training Task Force, consultant screening will be completed within three to six months. Initial training will begin within twelve months and a full consulting/training program will be available within eighteen months.

6. Industry Benefits

Recent marketing innovations require a battery of new skills: set-up, measuring effectiveness, training and compensation of personnel, meshing with existing methods. These techniques offer particular benefit to domestic producers and can result in increased sales and profits and reduced field selling expenditures (by permitting field sales personnel to concentrate on major accounts and develop new business).

7. Benefits Quantification

Company by company sales cost reduction/sales generation improvement using new techniques could be measured.

Marketing

F. Export Trading Assistance

1. Description and Rationale

FIA will develop an export trading program for the domestic footwear industry which may include a non-competitive product consortium (trading company), education, training, and information and coordinating participation in overseas trade shows or events. The domestic industry would benefit from a central point of export training and information. All the above activity assumes close liaison with appropriate offices in the Department of Commerce and other government agencies.

2. Development Responsibilities

FIA's Marketing and National Affairs Division will form an Export Opportunity Task Force (reporting to the Marketing Steering Committee and the National Affairs Steering Committee) to develop program elements along with Marketing Division executive.

3. Methodology/Management

FIA Marketing Division executive will act as program coordinator and will liaison with National Affairs Division director. Outside industry export consultant may serve as overall program administrator.

4. Methodology/Finance

All programs will be funded by the industry members. Participation at foreign trade shows will also be on a shared expense basis.

5. Timetable and Check Points

Planning can begin immediately by Marketing Steering Committee. Task Force will be formed and meet within three months. Industry (suppliers and manufacturers) will be surveyed as to current/desired level of export activity. Outside consultant will be retained and seminar programs offered within six to twelve months. Consortium will be organized within twelve to eighteen months. Participation in overseas trade shows will also begin immediately. Informational bulletin (already available) will broaden its coverage to include FIA activities.

6. Industry Benefits

Although foreign import quotas and duties have made exporting footwear difficult, some domestic companies have succeeded. By organizing a centralized program to take advantage of government programs, industry expertise and foreign marketing opportunities, FIA can help the domestic industry more efficiently use its production capacities and inherent product strengths.

7. Benefits Quantification

Particularly for companies beginning an export program, results are highly measurable. For companies already engaged in export, change in sales/profitability levels can be measured.

Marketing

G. Computer Software Specific to Footwear Industry

1. Description and Rationale

FIA will oversee development of universal computer marketing software specifically designed for domestic footwear producers and suppliers. Such areas as order entry, merchandising, territory analysis, sales forecasting, production and sales flow, budgeting, etc., will be covered, style/pricing/outlet analysis, will be considered. This has been done by some companies. A central software clearinghouse, planning group, and integrated program would be very cost and time-effective for the industry, particularly smaller and medium-sized companies.

2. Development Responsibilities

Development will be the responsibility of FIA Marketing Division executive and Marketing Steering Committee. An ad hoc Marketing Software Development Task Force may also be established.

3. Methodology/Management

FIA's Marketing Division executive will act as program coordinator. Outside professional consultant (and head of Marketing Software Development Task Force) may serve as liaison.

4. Methodology/Finance

Each software element will be underwritten by industry members prior to development. Additional revenue generation (from training and software sales) would reimburse original underwriters.

5. Timetable and Check Points

Planning will begin immediately by Marketing Steering Committee. Task Force will be formed and meet within three months. Pooled software needs will be identified by industry survey within nine months. Outside consultant will be retained and pilot software programs developed within fifteen to eighteen months.

6. Industry Benefits

More and more domestic footwear companies are developing their own computerized software for internal marketing planning and control. These software systems can be more cost-effective, efficient, and beneficial if a centralized, organized approach is used within the industry for their development. Software can also more easily integrate available consumer purchase data. Another dimension of the advantage this offers the domestic industry is more timely retailer response. There are now available to marketing management a broad range of software tools (research, product movement, financial databases, text, search, media, simulated test marketing, etc.) which can be adapted to footwear.

7. Benefits Quantification

Results will be difficult to measure on an overall basis; however, individual companies will derive measurable changes in cost efficiency, opportunities for increased sales due to more rapid analytical turn-around.

5 YEAR PLAN OF ACTION—MARKETING

BASIC COMPONENTS	OBJECTIVE OF WORK	RESPONSIBILITY	MANAGEMENT	FINANCING	TIMETABLE						BENEFITS
					85	86	87	88	89	90	
PRODUCT DESIGN	Training to produce domestic footwear stylists and line builders with authentic fashion sense, timeliness and CAD capability	FIA & Industry	FIA Task Force with Consultants & Academia (FIT, Parsons, etc.)	FIA & Industry	D	D	X	>	>	>	Improvement in design freshness and authenticity Shortening of lead time to get ideas to market
CONSUMER RESEARCH AND EDUCATION	Develop and train industry in use of systems for more effective consumer research										Opportunity for savings in marketing costs through targeted sales efforts, more productive promotional programs, identification of new market opportunities
	• Foot/Track	FIA & Industry	FIA Training Task Force with Consultants	FIA & Industry	X	>	>	>	>	>	
	• Market research seminars	FIA & Industry	FIA Training Task Force with Consultants	FIA & Industry	X	>	>	>	>	>	
	• Focused consumer studies	FIA & Industry	FIA Training Task Force with Consultants	Government & Industry Grants	X	X	X	X	X	X	
SALES MANAGEMENT TRAINING	Develop generic footwear industry training program focused on sales management skills and functions	FIA & Industry	FIA Training Task Force with Academia	FIA & Industry plus possible Government or Private Grants							Enhanced skills of sales management plus shorter time period for achievement of management competence
	• Sales Management Skills Development (SMSD)				X	>	>	>	>	>	
	• SMSD Enhancements				D	D	X	>	>	>	
STRATEGIC PLANNING AT CORPORATE AND MARKETING LEVELS	Develop strategic planning skills at senior levels of industry management	FIA as catalyst Selected Business Schools and Consultants	FIA Senior Task Force identify programs from Academia/Consultancies Create seminars to inform management and encourage use with key executives	FIA & Industry	X	X	>	>	>	>	Improved senior management ability to guide business strategies

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QUALITY + = improvement in product quality
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5 YEAR PLAN OF ACTION—MARKETING *Continued*

BASIC COMPONENTS	OBJECTIVE OF WORK	RESPONSIBILITY	MANAGEMENT	FINANCING	TIMETABLE						BENEFITS
					85	86	87	88	89	90	
STATE-OF-THE-ART SALES AND MARKETING TECHNIQUES	Create industry awareness of new and developing sales and marketing technologies such as: • Direct Response • Catalog • Telemarketing • Computer to computer stock replenishment • In and outbound telephone sales	FIA & Industry	FIA Marketing Steering Committee with Consultants and FIA Task Forces where appropriate Close liaison with retail associations	FIA & Industry	X	X	X	X	X	X	Sales increases through better use of available distribution channels and methodologies
EXPORT TRADING ASSISTANCE	Create industry-wide awareness of export opportunities and provide training on how to export effectively • Information flow • Trading consortia • Education/Training	FIA & Industry plus Government Agencies	FIA Task Force	FIA & Industry plus possible Government (TAA) Grants	X	X	X	X	X	X	Increased sales
COMPUTER SOFTWARE SPECIFIC TO FOOTWEAR	Creation of footwear specific software for key marketing applications to permit rapid, cost effective adoption of computer aided systems such as:	FIA & Industry	FIA Marketing Steering Committee plus FIA Task Forces and Consultants where appropriate	FIA & Industry plus possible Government (TAA) Grants							Decreased overhead costs, shorter lead time More accurate and timely customer service
	• Order entry and control				D	D	X	>	>	>	
	• Merchandising				D	D	X	>	>	>	
	• Forecasting				D	D	X	>	>	>	
	• Sales force management					D	X	>	>	>	

D = Under Development
X = Operational
> = Ongoing Activity

MAT = % savings in factory selling price
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O'HEAD = % savings in factory selling price

QUALITY = [illegible] improvement in product quality
TIME = # of days reduction in cycle time for bringing a new product to market. Assumes current average cycle time for new product requiring new last, new patterns, new heels, etc. is 150 days from concept to delivery

STATEMENT OF

DAVID C. HAWLEY, DIRECTOR OF FEDERAL PUBLIC AFFAIRS, INLAND STEEL COMPANY

ON BEHALF OF

THE AMERICAN IRON AND STEEL INSTITUTE

TO THE

COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS

SUBCOMMITTEE ON ECONOMIC STABILIZATION

U.S. HOUSE OF REPRESENTATIVES

ON THE GROWING PRESSURE FOR IMPORT PROTECTION

AND POSSIBLE POLICY RESPONSES TO THIS ISSUE

JUNE 26, 1985

I am David Hawley, Director of Federal Public Affairs for Inland Steel Company and current Chairman of the Committee on International Trade of the American Iron and Steel Institute (AISI). This statement is offered on behalf of the AISI, whose 50 domestic member companies account for about 79 percent of the raw steel produced in the United States. Accompanying me is Mr. Frank Fenton, AISI's Vice-President for International Trade and Economics.

Mr. Chairman, I want to express the appreciation of our Institute's members to you and the other Subcommittee members for your interest in holding this hearing and your interest in receiving testimony from the steel industry. As you know, our industry has had extensive experience with import problems and with policy responses to those problems. My testimony will focus on steel's own specific trade policy experience; on the variety of approaches which have been tried over the years to deal with the steel trade problem; and on the lessons learned by the steel industry. I offer these views in the context of the three major questions of this Subcommittee hearing, namely: (1) why certain U.S. distressed industries have pressed increasingly for trade relief; (2) what the effect of trade relief has been on U.S. industries and the policies of our foreign competitors; and (3) what the role of adjustment should be in the trade relief process.

Why the Steel Industry Has Sought Trade Relief

In answering the first of these questions -- why the American steel industry has sought trade relief -- one need only look to the massive evidence of nearly three decades of foreign unfair trade practices, and to documented findings of the long-term damage done to our industry by foreign targeting, subsidies, dumping and protection of the home market.

To begin with, the U.S. Department of Commerce has made scores of antidumping and countervailing duty rulings against foreign steelmakers in recent years, and in many of these cases it has found substantial margins of unfair trading ranging from 20 to 100 percent or more. The October 1982 U.S.-European Community (EC) Basic Steel Arrangement was itself a direct result of major subsidy and dumping findings made against numerous EC producers in August of 1982. What these and other unfair trade rulings have made clear is that it is the continuing largesse of foreign governments which has made it possible for inefficient foreign steel firms to maintain and even modernize their facilities.

The November 1984 Trade Subcommittee report of the tripartite Steel Advisory Committee points out that approximately 30 percent of free world steel production outside the U.S. is owned by governments; that nearly half of total European Community (EC) production is under direct state control; and that government ownership throughout the developing world is now the norm. In addition, this report confirms that governments in

Japan, the EC and certain developing countries have all resorted to tight home market protection to sustain their steelmaking production. Finally, it exposes as false the idea that comparative advantage is at work today in the shift of steel production to the developing world. It does so by noting that "even with all of the advantages of government funding, import protection and lower wage rates, many developing country plants are still operating largely in the red."

Additional evidence of foreign unfair trade practices was developed over the last year, when the U.S. International Trade Commission and an independent Washington law firm each issued three major studies on foreign industrial targeting. These studies concluded that Japan, the EC and major advanced developing countries have all, at one time or another, targeted steel as a "chosen industry" to promote exports, save jobs or generate foreign exchange earnings. Moreover, the AISI also issued a document in 1984 entitled "World Steel Profiles", which I would be happy to provide to this Subcommittee. This was our own initial attempt to compile a summary of unfair trade case findings and foreign unfair trading practices (as reported in published articles). While it is neither complete nor fully up-to-date, it too describes in considerable detail how foreign governments throughout the free world have aided their steel industries through massive subsidies and extensive protection of the home market.

Largely as a result of foreign unfair trade practices and foreign government ownership, control and management of steel, there has been a world steel crisis since 1975. It is characterized today by nearly 200 million tons of excess world steelmaking capacity. For U.S. producers, it has meant record surges in imports of unfairly traded steel and a depression more acute than anything experienced since the 1930s. The damage done to domestic steel producers by unfair trade includes billions of dollars in lost sales and profits, and a severe cash flow squeeze that has seriously affected our ability as an industry to modernize plants and equipment. In addition, our nation has suffered hundreds of thousands of jobs lost in the steel industry, both directly and indirectly in related supplier industries, as well as billions of dollars in lost tax revenues to the federal, state and local governments.

Therefore, in answering the question of why domestic steelmakers have sought trade relief, it is important to understand that, since the United States market has remained the world's largest, most open target for excess foreign steel capacity, we have suffered disproportionately from the world steel crisis. Simply stated, we have sought trade relief, because years of foreign unfair trading and attempting to compete with foreign governments have eroded our financial condition as an industry, driven some of our companies out of business entirely, and threatened the viability of all major U.S. integrated steel firms.

The Effect of Trade Relief on the U.S. Steel Industry and on Our Foreign Competitors

In regard to the Subcommittee's second main concern, which is the effect trade relief has had on the U.S. steel industry and on our foreign competitors, it is important to review very briefly the history of the various types of relief which have been granted to domestic steel producers over the years.

Two primary examples of less than successful steel trade programs are the 1969-74 steel Voluntary Restraint Agreements (VRAs) and the 1978-81 Trigger Price Mechanism (TPM). The key problems with the VRAs were insufficient country coverage and product detail, and inadequate enforcement mechanisms. The key problems with the TPM were (1) that it allowed the Europeans and other non-Japanese suppliers to engage in massive dumping as long as they sold steel in the U.S. market above Japanese costs of production, and (2) that evasion of the system was too easy.

In addition, U.S. trade laws have also been largely unsuccessful in providing meaningful relief to the steel industry over the years. The effectiveness of U.S. trade law relief has been limited partly because foreign policy or other concerns have frequently affected the government's will to enforce the laws, and partly because of deficiencies in the laws themselves. In 1977, President Carter admitted that the

Treasury Department had been "derelict" in enforcing the trade laws. In 1979, U.S. trade laws were strengthened in ways to make them more useful to injured U.S. industries. However, a number of critical trade law deficiencies remain, and steel and other industries therefore continue to support legislative prosposals, such as the recently introduced Comprehensive Trade Law Reform Act of 1985 (H.R. 2809), to deal with these problems.

The extent to which U.S. trade laws and programs have thus far failed to deter our foreign competitors from unfairly trading steel in the U.S. market can be seen in the numbers: a steadily rising U.S. import market share, made possible largely by selling steel in the U.S. market at dumped and subsidized prices. In the 1950s, imports averaged 2.3 percent of the market; in the 1960s, they averaged 9.3 percent; in the 1970s, they averaged 15.3 percent; and last year, imports took a record 26.2 percent share of the U.S. market.

It is also worth pointing out that 1984 saw a record 59 foreign suppliers ship steel to the United States. Thus, a key problem which has emerged in recent years is that the source of America's steel trade problem is forever shifting from one foreign supplier to another and from one product line to another -- while the magnitude of our steel trade problem is forever growing, due to an ever-increasing total number of suppliers. As a result, we have been left with a "revolving door" of foreign steel suppliers willing to sell steel in the U.S. market at almost any price. It was precisely this realization which led both the

U.S. industry and the U.S. government last year to consider a more comprehensive approach for dealing with the steel trade problem.

In 1983 and 1984, while individual domestic steel producers continued to file unfair trade petitions, the American Iron and Steel Institute strongly backed comprehensive quota legislation designed to limit steel imports in all products from all foreign sources to no more than 15 percent of the U.S. market for five years. Last year, Bethlehem Steel and the United Steelworkers filed a Section 201 "escape clause" petition which sought parallel comprehensive relief. Ultimately, as this Subcommittee well knows, the President announced last September that the U.S. Trade Representative's (USTR) Office would begin negotiations on a series of bilateral surge control Arrangements aimed at limiting, for five years, annual finished steel imports to no more than 18.5 percent of the market and annual semi-finished imports to 1.7 million tons; and the Congress passed in October the Steel Import Stabilization Act, giving the United States clear authority to enforce these Arrangements at the U.S. border and expressing the will of Congress that total steel imports be limited to between 17 and 20.2 percent of the market.

I do not want to leave the issue of the effectiveness of steel trade relief without commenting briefly on the President's program announced last September. Above all, we are extremely appreciative of the outstanding effort and diligence shown thus far by U.S. negotiators under the leadership of Deputy USTR Robert Lighthizer. At present, the U.S.

has obtained 14 surge control Arrangements with foreign governments, including such major suppliers as Japan, Korea and Brazil. However, much more remains to be accomplished before this program can achieve its goal, which is to give the American steel industry a five-year respite from surging imports so that it can modernize its facilities and put itself in a much better position to compete fairly in the U.S. market with any and all foreign steelmakers.

First, it is absolutely critical that Europe be brought fully into the fold of the President's program. For this to occur, it is essential that the U.S.-EC negotiations which have now begun result in coverage, by export licenses and at the 1981 import penetration levels, of all of the so-called "consultation products" in the 1982 U.S.-EC Basic Arrangement where these have exceeded their 1981 levels. It is equally vital that the U.S. begin at once negotiations (1) to extend, until September 1989, the 1982 U.S.-EC Basic Arrangement and the January 1985 U.S.-EC Pipe and Tube Arrangement, (2) to eliminate the distinction between licensed and consultation products and (3) to provide coverage for all products -- including "licensed", "consultation" and "pipe and tube" by an export license and certificate system.

Second, given the recent surges in U.S. imports from such formerly minor foreign suppliers as Singapore, Israel, India, Portugal and Thailand, it is terribly important to ensure that no presently uncovered foreign supplier -- including such major suppliers as Canada and Sweden -- be allowed to disrupt the Arrangement system by surges in exports to the U.S. market.

And third, it is crucial to make certain that, during the last few months of 1985, when some of the covered foreign suppliers will be forced to cut back substantially on their exports to the U.S. market in order to meet their allowable tonnages for the initial period, this process of major cutbacks not be used by foreign suppliers or U.S. importers as an excuse or loophole for artificial and contrived claims that a short supply situation exists.

If these problems can be dealt with promptly and with the same resolve U.S. negotiators have shown so far in getting the President's program started, we believe this program has a real chance to succeed where the others have failed. It is still too early to predict precisely how successful the program will be in producing its expected result of an 18.5 percent limitation on the finished steel products' share of the U.S. market or the 1.7 million ton cap on semi-finished imports. My own view is that, if the program is fully implemented and effectively enforced, it should generate a trade environment in which the domestic steel industry can regain its financial health as well as its competitive edge.

The Role of Adjustment in the Trade Relief Process

This brings me to the Subcommittee's third concern, which is the view of the steel industry on the role of adjustment in the trade relief process. On this point, it is essential to understand, first of all, what domestic steel producers have been doing in recent years to adjust to foreign competition, and what we have agreed to do in the context of the comprehensive trade relief sought and granted in 1984.

The American steel industry has not just waited passively for government help, but has been engaged in massive self-help efforts in recent years. Peter Marcus of Paine Webber and Charles Bradford of Merrill Lynch now estimate that our industry has reduced costs by 15-20 percent in the last two years, and Mr. Marcus has reported in his "World Steel Dynamics Model" that the U.S. industry has so increased its productivity in the last several years that it now takes only 6.2 man-hours to produce a net ton of carbon steel in the United States -- compared to 6.8 man-hours in Japan, 9.7 in West Germany, 10.3 in France and 10.7 in Great Britain. During this same time, we have also greatly increased our "yield" (from raw steel to shipments of finished products). This has been due largely to our nearly doubling the number of continuous casters in operation in the last five years, and to our increased use of computerized process controls.

We know, of course, that much more must be done before we can say we have solved our international competitiveness problem. We will continue to reduce the cost of energy, raw materials and all other major inputs which go into the steelmaking process. On the issue of labor costs, for example, we must continue to build on the excellent beginning made in the 1983 contract, by reducing still further the so-called steel industry wage "premium" (above the all-manufacturing average) as well as the differential between U.S. and foreign steel labor costs. At the same time, we will continue to stress the need for more flexible steel plant work rules, and to improve the quality of the steel produced in our plants through better worker-management cooperation.

In addition to our strong commitment to revitalizing our industry by our own efforts, we have supported legislative proposals which recognize the importance of the role of adjustment in the trade relief process. Last year, for example, we supported a modernization quid pro quo provision in the steel quota bill which would have allowed the steel import limitations to lapse if the Secretary of Commerce found that the steel industry was investing substantially less than the cash flow generated by steel operations. We also agreed to support a provision in the 1984 Steel Import Stabilization Act which requires, as a condition of continued enforcement of the bilateral Arrangements negotiated under the current program, that the largest domestic steel companies reinvest substantially all of the net cash flow from steel operations back into modernization.

By any accounting, we have put much more investment capital into steel operations over the last decade than the cash flow we have received back from steel operations. Recent figures bear this out most dramatically. Despite the more than $6 billion in losses suffered by domestic steel companies since 1982, U.S. steelmakers have invested some $5.5 billion in steel plant modernization over the last three years. In doing so, our companies have had to increase their debt-equity ratio to perilous levels -- over 90 percent at the end of 1984. This hardly bears out the caricature, so often portrayed in the media, of an industry that has simply refused to spend the necessary funds on modern facilities.

Unfortunately, the major capital expenditures made by our industry in recent years are still far short of what needs to be done. According to estimates in the recent Steel Advisory Committee report, capital requirements to maintain and modernize equipment need to average about $5.5 billion per year between 1984 and 1989; so that even with the President's steel trade program fully implemented, our yearly capital shortfall is expected to be somewhere between $1.5 and $2 billion. Thus, the American steel industry is continuing to face a major international competitiveness problem, but this problem stems neither from an unwillingness to modernize nor from a lack of technological know-how. It is due simply to a lack of available cash.

Make no mistake about it. We are determined to use the current five-year period of the President's trade program as a "window of opportunity" to continue to establish world-class facilities in our industry. This is precisely why we remain so terribly concerned about our continuing capital formation crisis. For this crisis to be resolved and for our industry to regain its competitive edge, we need our government policy makers to recognize that steel industry adjustment is a function of steel industry cash flow. To resolve our capital starvation problem will require prompt completion -- and vigorous enforcement -- of the President's trade program, and pro-investment government policies which will encourage not only domestic steel companies but also important steel-consuming industries to increase their expenditures for new plant and equipment in the United States.

Steel's Adjustment in the Context of America's Eroding Manufacturing Base

The Subcommittee has also expressed an interest in our views on trade policy and competitiveness issues in general. Since the economic future of domestic steel producers is tied directly to the future health of America's key steel-consuming industries, we are deeply concerned not just about the current state of steel industry competitiveness, but also about the continuing erosion in America's entire manufacturing base. In the last four years alone, the U.S. trade balance in manufactured goods has gone from a $12 billion trade surplus (in 1980) to an $89 billion trade deficit (in 1984). Meanwhile, America's indirect steel trade balance (trade in goods containing steel expressed in terms of tons of steel) went from a rough balance in 1980 to a 6.4 million ton deficit in

1984. This negative trend must be reversed, for it will not be possible to revitalize the American steel industry if our major customer industries continue to decline.

It has been estimated that each $1 billion in the U.S. trade deficit costs our economy about 25,000 jobs, and America's total trade deficit reached $123 billion last year. Thus, we ended up shipping about three million jobs overseas in 1984. The Bureau of Labor Statistics (BLS) recently estimated that some 2.3 million manufacturing jobs have disappeared in the United States since 1980. Since it is clear that the overvalued dollar and the growing U.S. trade deficit have contributed greatly to the loss of U.S. manufacturing jobs, it should be the highest priority of U.S. economic policy to reduce the foreign exchange value of the dollar and the trade deficit. However, it is not enough merely to point to the high value of the dollar for the continuing erosion of America's manufacturing base, because there are a number of other significant causes -- including foreign unfair trade practices. And these affect not just steel but steel's customers and their customers, too.

We also believe that it is naive merely to point to some kind of alleged "natural shift" going on from basic manufacturing to services and high technology. First of all, a strong U.S. economy and U.S. national security require a strong U.S. manufacturing base. U.S. high technology industries require viable U.S. manufacturing firms to purchase their products. And U.S. service industries provide generally lower-paying jobs which generate much less domestic spending than jobs in manufacturing. In addition, it is clear that precisely the same kinds of foreign unfair trade practices which have so injured basic U.S. manufacturing industries have now begun to erode the competitiveness of U.S. service and high technology industries.

Given what is occurring accross the board in terms of declining U.S. international competitiveness, we would conclude with the following four general recommendations:

- U.S. trade policy makers should stop pretending that the rest of the world is dedicated to free trade principles when it is not.
- U.S. policy makers should recognize once and for all that it is not possible for any American firm -- regardless of how efficient it is -- to be able to compete against the vast resources of foreign governments.
- Both the Administration and the Congress should review carefully all of America's economic policies from the standpoint of whether they promote or hinder U.S. international competitiveness.
- And U.S. trade laws should be thoroughly modernized and strengthened, for these remain -- despite their deficiencies -- an essential self-defense against the ravages of unfair trade.

MANAGING WORLD TRADE: OFFSETS

WEDNESDAY, JULY 24, 1985

House of Representatives,
Subcommittee on Economic Stabilization,
Committee on Banking, Finance and Urban Affairs,
Washington, DC.

The subcommittee met, at 10:10 a.m., in room 2220, Rayburn House Office Building, Hon. John J. LaFalce (chairman of the subcommittee) presiding.

Present: Chairman LaFalce; Representatives Vento, Kaptur, Levin, Shumway, McCandless, and Grotberg.

Chairman LaFalce. The Subcommittee on Economic Stabilization will come to order.

The purpose of this morning's hearing is to explore in detail the growing significance of countertrade and offset arrangements in regard to foreign purchases of American goods and services, and the impact of this phenomenon on the competitive position of U.S. industries.

Increasingly, such arrangements are required by foreign buyers as a condition of the sale in order to counter or offset the economic impact of the sale on the purchasing country. These arrangements take many specific forms, including requiring subcontracting to firms in the purchasing country, coproduction of certain items, technology transfer, or the purchase of goods from the buyer country by the U.S. seller.

While the specific mechanisms differ, the purpose is the same—to help the economy of the purchasing country, its industrial base, its employment, its balance of payments. It is increasingly apparent that the impact on our own industrial base, our own employment, our own balance of payments and, ultimately, the competitive position of our industries is substantial.

Offset arrangements raise many difficult issues. Our most basic problem is a continuing dearth of information. In the course of the subcommittee deliberations on this issue last year, it became clear to us that there is virtually no reliable data base which could be used to analyze these practices and make judgments regarding appropriate policy responses.

In an effort to correct this serious deficiency, last year the Congress passed legislation recommended by this subcommittee that mandates annual reports regarding the impact of offset and countertrade arrangements. The subcommittee anxiously awaits the issuance of the first report in October of this year.

But, while it is critical that we have the data, the policy we formulate in response to what the data reveals is of primary importance. The policy issues are complex. U.S. firms will argue that, in many cases, increased competitive pressures make it impossible for them to conclude a deal with a foreign purchaser without agreeing to an offset arrangement. Companies fear that government interference regarding offset requirements could harm their sales prospects.

Yet, there are important public policy issues we cannot afford to ignore. The report prepared for this subcommittee last year by the General Accounting Office pointed out that foreign governments are putting increased pressure on American companies for these economic concessions. Although offsets in foreign military sales have been the most common type of arrangements in the past, it is clear that the theory of playing off two potential sellers against each other can readily apply to other big-ticket items such as telecommunications, energy, transportation systems, et cetera. There is evidence that such practices are spilling over from military sales into general commercial trade.

As demands increase, the impact on our own industrial base and the future competitive position of our industries could be profound and irrevocable. Our Government must be concerned about whether we are inappropriately shipping American technology and American jobs overseas.

Offset arrangements affect several billions of dollars of international trade each year. Yet information remains sketchy; the reluctance to confront the issue, great; and a coordinated government policy not in evidence. Today we want to examine what the administration intends to do about developing a policy to deal with these issues.

We are pleased to have with us today the following witnesses who can give us more information about offset practices, and how the administration intends to address this issue: Walter J. Olson, Jr., Deputy Assistant Secretary for Export Administration of the Department of Commerce; James R. Blaker, Deputy Assistant Secretary for Policy Analysis of the Department of Defense, and Joel Johnson, vice president for economic affairs of the American League for Exports and Security Assistance, accompanied by David Scott of the Lockheed Corp. and John Kirkland of the FMC Corp.

Now I call upon the ranking minority member of the subcommittee, Representative Shumway of California.

Mr. SHUMWAY. Thank you, Mr. Chairman. I would like to join with you in welcoming this distinguished panel of witnesses. Like you, I look forward to their testimony.

Needless to say, the issue of offset and countertrade arrangements is one of growing magnitude. Their role in the U.S. contracts—whether military or private commercial endeavors—has increased substantially in the last 15 years. And as their presence in the international trading arena has increased, so too has their impact on this Nation's industrial and security interests.

This subcommittee must determine whether offset practices serve a beneficial purpose to this Nation's interests or whether such programs increase competition from foreign countries and, in the process, compromise industrial and security goals for the improved economic positions of offset recipients.

I believe that offset arrangements do represent a legitimate means to enhance the national defense interest of the United States. Indeed, they create closer ties with our allies by bolstering mutual defense capabilities and strengthening their overall economies. At the same time, these arangements generate a commonality of weapons systems, lower costs and create new U.S. jobs.

On the other hand, these practices can often become enforced incentives and produce perverse distortions in our trade system. In particular foreign government mandated offsets erode the U.S. industrial base, result in technology transfers returning to the United States in the form of commercial competition, create an unfavorable balance of payments, reduce tax revenues, decrease U.S. jobs, increase costs, and ultimately subsidize foreign industry. These are concerns which should not be taken lightly.

We should also not overlook the fact that these arrangements are no longer limited to foreign military sales transactions. Indeed, these practices have spilled over to the private commercial sector as well. Private corporations have become reluctant international traders of all sorts of products in order to do business overseas. While it is not illegal for U.S. companies to offer countertrade to win a contract, the ramifications on the trading system and our economy may be great.

Critics of these arrangements have pointed to the need for a national policy to eliminate their adverse effects. Before we follow this course, however, I would suggest that two other points must be considered.

First, these arrangements are concluded by the private—and I stress private—sector, based on its assessment of market conditions. If a company, particularly one involved in a purely commercial transaction, determines that offsets or countertrade arrangements are necessary in order to obtain the foreign contract, then why should the Government intervene into a pure business decision?

Second, we must recognize that these arrangements reflect a global political problem. A unilateral U.S. policy will have little impact in the absence of major efforts toward inducing a political consensus among major countries that offsets and countertrade arrangements are, in fact, a problem. Moreover, the global trading countries must recognize that steps need to be taken immediately to preserve an orderly international trading system. I believe that this political dimension needs to be emphasized in any discussion we have on this topic.

Mr. Chairman, I hope that our witnesses today will shed some light on the nature and magnitude of this problem and, perhaps, provide some cogent suggestions as to how this subcommittee can best fashion a workable solution.

For that reason, I look forward—as you do—to their testimony. Thank you.

Chairman LaFalce. Thank you, Congressman Shumway.

I think without a doubt the member of the subcommittee, and of the Congress most interested in this issue and most interested for a long period of time has been Representative Vento. So, if there is any comment you would like to make?

Mr. Vento. Thank you, Mr. Chairman.

Let me commend you, first of all, for holding this hearing in search of a policy on offsets which is, indeed, a worthy effort. The policy so far is no policy and that, I think, has brought us to a situation where we have unorganized and obviously detrimental activities going on with regard to the industrial base.

The concern here, of course, is the concern in terms of the loss of technology, the loss of jobs, the loss of our industrial base. While in many instances there may be concerns that the private sector has been free to do this, all too often, I think, the government-to-government contracts for weapons systems and for the tremendous investment that we make in high tech is in fact negotiated away by the DOD and others that are concerned about placing or making weapons sales to our various allies.

That indeed has been, through memorandums of understanding and other agreements, and looking at the trading policy and actions of allies and Third World nations, we find that often their laws in fact mandate a certain percent of offset requirements before something is purchased.

So, in an environment in which we have a backdrop, in which we are pushing toward a $160 billion balance of trade deficit this year, it just seems to me that we ought to look very hard at an area where we have and are investing tremendous amounts of our technology and where indeed that technology is being transferred en masse to other nations who then will begin building products and sending them back here.

So, I think just fair play demands that we do develop a policy, a nonpolicy is not a policy with regard to this. In spite of all the comments that are made for the policy, I am looking forward to the report. But I do think that we have played an active role. The National Government has played an active role and we will continue to probably do so. I do not think we are going to let them run away from that particular responsibility and the consequences of what their actions have been.

Thank you, Mr. Chairman.

Chairman LaFalce. Thank you very much, Mr. Vento.

We will now hear from the witnesses and, before we do, I would like to make two statements to them.

No. 1, in order to expedite matters, we will put the entire text of your remarks in the record, and I hope you will feel free to summarize your remarks.

Let us begin. Our first witness will be Mr. Walter Olson, Deputy Assistant Secretary for Export Administration.

STATEMENT OF WALTER J. OLSON, DEPUTY ASSISTANT SECRETARY FOR EXPORT ADMINISTRATION, DEPARTMENT OF COMMERCE

Mr. Olson. Thank you very much, Mr. Chairman. I think, with your permission, I will read my prepared statement. I think I can get through it in about 7 minutes. It essentially summarizes the position of the Department of Commerce.

First, I am pleased to have the opportunity to appear before the Subcommittee on Economic Stabilization to discuss the complex issue of offsets. As you are aware, offsets have become the subject of increasing interest for both the Congress and the administration.

The administration shares the subcommittee's interest regarding the potential effect offset agreements have——

Chairman LaFalce. They may share it now, but it took an awful lot of work to get them to accept submission of the report. [Laughter.]

Please continue.

Mr. Olson. All right.

The potential effect offset agreements have on the competitiveness of the Nation's industrial base and our trade balance.

In keeping with the Department of Commerce's role in analyzing this important issue, I will confine my remarks this morning to the economic implications for U.S. competitiveness of offsets in military trade. Consequently, my discussion will center on offsets or military export sales which involve compensatory obligations mandated by the purchasing government as a condition of sale.

I will not concentrate my remarks on countertrade of commercial trading transactions which require the purchase of goods or services from the importing country as a condition of the sale, and I will leave to my colleague from the Department of Defense the task of addressing any direct national security considerations which may pertain to offset agreements.

We believe that offset agreements are being employed more extensively in military and other trade than previously. Also, some have become more intricate in terms of scope of countertrade required and the dollar value of the agreements signed. We believe offsets are increasingly becoming integral tools of the trade and military procurement policies of many of our trading partners.

The government of one newly industrialized nation, for example, recently implemented an offset program for all government purchases that exceed $1 million. The plan calls for an offset target of 50 percent of the value of the purchase and mandates that at least 20 percent be provided in direct offsets.

The objective here is to promote the development and expansion of industrial and manufacturing capabilities. The specific goals are to "obtain new technology, provide——

Chairman LaFalce. What is that newly industrialized nation?

Mr. Olson. That's Korea, South Korea.

The specific goals are to "obtain new technology, provide design and development work, assist under-utilized sectors of industry, selectively stimulate sectors of the economy and create new employment opportunities."

This trend of using offsets as a tool of governmental trade policy is not limited to newly industrialized and developing countries. Many NATO countries, as well as Japan and Australia, have incorporated increasingly significant offset requirements as a condition of weapon systems purchases. In many cases, these offset requirements have included technology transfers which have military or commercial applications as well as distinctly nonmilitary indirect offsets.

Chairman LaFalce. Let me just stop you there. This is not something that is strictly between private sector and private sector. You are saying that this is government policy by law or by regulation, or by fiat; correct?

Mr. **Olson**. Well, when we sell military systems, they are to foreign governments as opposed to private sector entities in the other country. However, the U.S. partner in that transaction would be, Mr. Chairman, a U.S. private firm.

Chairman **LaFalce**. The U.S. interested party.

Mr. **Grotberg**. Mr. Chairman, one point. Every other word is "offset." You might just take the time—I think I know exactly what offset is, but would you define the term so that we all understand?

Mr. **Olson**. Well, Congressman, you raise a good question here on definitions. [Laughter.]

I think this troubles us all. I think we have a working definition. Generally, in the context of my remarks today, I was trying to utilize the term "offsets" to refer to those military sales agreements that involve a codevelopment or coproduction of a portion of that contract in the overseas country, as opposed to countertrade which is not an accepted definition. But in terms of the remarks I am making today, we feel that countertrade has to do more with commercial transactions such as TV sets or oranges, or something on those lines.

Now, it is true that in military offset agreements there can be elements of countertrade such as the sale of a weapons system and as a part of that, the U.S. firm would undertake certain responsibilities such as in the area of promoting tourism for that other country in this country.

Chairman **LaFalce**. Please continue.

Mr. **Olson**. All right.

It is obvious that offsets involve some potential for negative economic impacts on our industrial competitiveness. It is equally true, however, that offsets are an integral part of our foreign and national security policy, and, as such, have important political and strategic implications.

We are advised that offsets are a key component of our policy of strengthening the industrial and defense bases of our allies. They have become an important factor in achieving a number of foreign policy and national security objectives.

Further, there is a compelling logic that offsets, in the short run, make sense in the prevailing economic environment. The growing importance of offsets is linked, in large part, to the economic and debt servicing problems of friendly nations. This is particularly true of the less developed nations. The debt problems of many of these nations have been so severe that reschedulings and moratoria have resulted and, moreover, foreign exchange control by central banks and the threat of further rescheduling have lessened the availability of credit for trade finance. These trends have shown some improvement in recent years, but the availability of foreign exchange for military and other trade purchases remains a serious problem for many of our trading partners.

Even our more affluent allies are hard pressed to afford the up-to-date military systems and hardware. The trend in fighter aircraft has been toward increasingly more capable, versatile, and technically sophisticated aircraft.

The United States unquestionably produces the finest fighter aircraft systems in the world today. But quality does not come cheap, and these aircraft are expensive. The fact that they are well worth the money does not change the fact that purchasing nations face major problems in coming up with the money to pay for them.

From the U.S. point of view, this problem is aggravated by another key emerging factor: Increased competition. For decades, the United States enjoyed a virtual monopoly in the free world export market. Our products were and remain superior, and our economies of scale provide us with a distinct price advantage. While our products remain superior, there are many more serious competitors than previously. Consequently, buyers have increased leverage, and offsets have become an increasingly important factor in making military export and other sales. In many cases, U.S. companies are faced with a choice between accepting less than optimum agreements which incorporate offsets, or losing sales.

There is no arguing the fact that offsets, like all forms of barter trade, are, to some extent, economically inefficient. It is important to remember, however, that they may be inefficient for buyer and seller alike. The United States is committed to making trade with our NATO partners a two-way street. Like all major changes to trade policy, this commitment can involve both costs and benefits. This is particularly true of military export sales. The establishment of expanded coproduction will, in all probability, involve significant transition costs, and will have some impact on our defense base. The point to be made is that offsets are complex and should be studied carefully. In weighing these costs and benefits, the role of offsets in attaining our foreign policy and national security objectives should be carefully considered.

The U.S. Department of Commerce is currently studying the impacts of offsets on U.S. industrial competitiveness. Our analysis is still underway. We have made substantial progress and have begun to analyze data that cause concern, particularly in the area of military offsets. While we are advised that offsets are a necessary and positive component of arming our allies, we feel there are some potential economic effects of the practice that warrant close scrutiny. These include:

The potential economic impacts of offsets on our defense infrastructure, particularly second- and third-tier subcontractors;

The potential erosion of U.S. competitiveness on nondefense sectors as a result of indirect technology transfers and countertrade associated with military offset agreements;

The fact that coproduction can, in some cases, increase the unit cost of some components of U.S. weapons systems;

The threat that offset agreements have the effect of creating competitors in the arms export market; and

The growing spill-over effect of military offsets into nonmilitary trade.

These concerns highlight the real challenge that we face in understanding the issue of offsets and other forms of countertrade. These forms of trade are an economic fact of life in the international marketplace. Each year, the world economy becomes a smaller place as competition for export markets intensifies. In view of these trends, it is clear that there is need for us to be flexible and open handed in our analysis of the role of offsets in the international marketplace.

I might also add that we are currently seeking a multilateral consensus on countertrade issues and improved information on which to base policy development decisions. The focus of our recent efforts was to work with the Paris-based Organization for Economic Cooperation and Development [OECD] to produce a major report on countertrade with developing nations. This greatly improved our understanding of the needs and issues involved. This was an initial effort to assess the use of countertrade by developing nations and parallels a similar effort analyzing East-West countertrade.

At the initiative of the U.S. Government, a study was prepared by the GATT secretariat on countertrade. The study reviewed the role of countertrade in meeting GATT policy objectives and provided an assessment of the impact of countertrade on world trade.

The U.S. Trade Representative, with support from Defense, Treasury, State, and Commerce, has initiated discussions with our major arms-producing allies to investigate the relative importance of offsets as perceived by purchasing nations. The results of these discussions will be presented as a section of the Defense Production Act offset report that will be submitted to this commitee.

These are some of the steps that are being taken to develop an understanding of the impacts of offsets and countertrade. The objective of this effort, like this meeting today, is to ensure that offsets and countertrade are properly understood, and that the economic, foreign policy, and national security needs of the United States are served to the maximum extent possible.

Thank you very much, Mr. Chairman. I will be glad to try to answer any questions that you might have.

[The prepared statement of Mr. Olson follows:]

STATEMENT OF WALTER J. OLSON
DEPUTY ASSISTANT SECRETARY
FOR EXPORT ADMINISTRATION
BEFORE THE
ECONOMIC STABILIZATION SUBCOMMITTEE
COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS
U.S. HOUSE OF REPRESENTATIVES

GOOD MORNING MR. CHAIRMAN, I AM PLEASED TO HAVE THE OPPORTUNITY TO APPEAR BEFORE THE SUBCOMMITTEE ON ECONOMIC STABILIZATION TO DISCUSS THE COMPLEX ISSUE OF OFFSETS. AS YOU ARE AWARE, OFFSETS HAVE BECOME THE SUBJECT OF INCREASING INTEREST FOR BOTH THE CONGRESS AND THE ADMINISTRATION.

THE ADMINISTRATION SHARES THE SUBCOMMITTEE'S INTEREST REGARDING THE POTENTIAL EFFECT OFFSET AGREEMENTS HAVE ON THE COMPETITIVENESS OF THE NATION'S INDUSTRIAL BASE AND ON OUR TRADE BALANCE. IN KEEPING WITH THE DEPARTMENT OF COMMERCE'S ROLE IN ANALYZING THIS IMPORTANT ISSUE, I WILL CONFINE MY REMARKS TO THE ECONOMIC IMPLICATIONS FOR U.S. COMPETITIVENESS OF OFFSETS IN MILITARY TRADE. CONSEQUENTLY, MY DISCUSSION WILL CENTER ON OFFSETS, OR MILITARY EXPORT SALES WHICH INVOLVE COMPENSATORY OBLIGATIONS MANDATED BY THE PURCHASING GOVERNMENT AS A CONDITION OF SALE. I WILL NOT ADDRESS COUNTERTRADE, OR COMMERCIAL TRADING TRANSACTIONS WHICH REQUIRE THE PURCHASE OF GOODS OR SERVICES FROM THE IMPORTING COUNTRY AS A CONDITION OF THE SALE. I WILL LEAVE TO MY COLLEAGUE FROM THE DEPARTMENT OF DEFENSE THE TASK OF ADDRESSING ANY DIRECT NATIONAL SECURITY CONSIDERATIONS WHICH MAY PERTAIN TO OFFSET AGREEMENTS.

WE BELIEVE THAT OFFSET AGREEMENTS ARE BEING EMPLOYED MORE EXTENSIVELY IN MILITARY AND OTHER TRADE THAN PREVIOUSLY. ALSO, SOME HAVE BECOME MORE INTRICATE IN TERMS OF SCOPE OF COUNTERTRADE REQUIRED, AND THE DOLLAR VALUE OF THE AGREEMENTS SIGNED. WE BELIEVE OFFSETS ARE INCREASINGLY BECOMING INTEGRAL TOOLS OF THE TRADE AND MILITARY PROCUREMENT POLICIES OF MANY OF OUR TRADING PARTNERS.

THE GOVERNMENT OF ONE NEWLY INDUSTRIALIZED NATION, FOR EXAMPLE, RECENTLY IMPLEMENTED AN OFFSET PROGRAM FOR ALL GOVERNMENT PURCHASES THAT EXCEED ONE MILLION DOLLARS. THE PLAN CALLS FOR AN OFFSET TARGET OF 50 PERCENT OF THE VALUE OF THE PURCHASE, AND MANDATES THAT AT LEAST 20 PERCENT BE PROVIDED IN DIRECT OFFSETS TO THE ITS ECONOMY. THE OBJECTIVE HERE IS TO PROMOTE THE DEVELOPMENT AND EXPANSION OF INDUSTRIAL AND MANUFACTURING CAPABILITIES. THE SPECIFIC GOALS ARE TO "OBTAIN NEW TECHNOLOGY, PROVIDE DESIGN AND DEVELOPMENT WORK, ASSIST UNDER-UTILIZED SECTORS OF INDUSTRY, SELECTIVELY STIMULATE SECTORS OF THE ECONOMY AND CREATE NEW EMPLOYMENT OPPORTUNITIES".

THIS TREND OF USING OFFSETS AS A TOOL OF GOVERNMENTAL TRADE POLICY IS NOT LIMITED TO NEWLY INDUSTRIALIZED AND DEVELOPING COUNTRIES. MANY NATO COUNTRIES, AS WELL AS JAPAN AND AUSTRALIA, HAVE INCORPORATED INCREASINGLY SIGNIFICANT OFFSET REQUIREMENTS AS A CONDITION OF WEAPONS SYSTEMS PURCHASES. IN MANY CASES THESE OFFSET REQUIREMENTS HAVE INCLUDED TECHNOLOGY TRANSFERS WHICH HAVE MILITARY/COMMERCIAL APPLICATIONS AS WELL AS DISTINCTLY NON-MILITARY INDIRECT OFFSETS.

IT IS OBVIOUS THAT OFFSETS INVOLVE SOME POTENTIAL FOR NEGATIVE ECONOMIC IMPACTS ON OUR INDUSTRIAL COMPETITIVENESS. IT IS EQUALLY TRUE, HOWEVER, THAT OFFSETS ARE AN INTEGRAL PART OF OUR FOREIGN AND NATIONAL SECURITY POLICY, AND AS SUCH HAVE IMPORTANT POLITICAL AND STRATEGIC IMPLICATIONS.

WE ARE ADVISED THAT OFFSETS ARE A KEY COMPONENT OF OUR POLICY OF STRENGTHENING THE INDUSTRIAL AND DEFENSE BASES OF OUR ALLIES. THEY HAVE BECOME AN IMPORTANT FACTOR IN ACHIEVING A NUMBER OF FOREIGN POLICY AND NATIONAL SECURITY OBJECTIVES.

FURTHER, THERE IS COMPELLING LOGIC THAT OFFSETS, IN THE SHORT RUN, MAKE SENSE IN THE PREVAILING ECONOMIC ENVIRONMENT. THE GROWING IMPORTANCE OF OFFSETS IS LINKED IN LARGE PART TO THE ECONOMIC AND DEBT SERVICING PROBLEMS OF FRIENDLY NATIONS. THIS IS PARTICULARLY TRUE OF THE LESS DEVELOPED NATIONS. THE DEBT PROBLEMS OF MANY OF THESE NATIONS HAVE BEEN SO SEVERE THAT RESCHEDULINGS AND MORATORIA HAVE RESULTED, AND MOREOVER, FOREIGN EXCHANGE CONTROL BY CENTRAL BANKS AND THE THREAT OF FURTHER RESCHEDULING HAVE LESSENED THE AVAILABILITY OF CREDIT FOR TRADE FINANCE. THESE TRENDS HAVE SHOWN SOME IMPROVEMENT IN RECENT YEARS, BUT THE AVAILABILITY OF FOREIGN EXCHANGE FOR MILITARY AND OTHER TRADE PURCHASES REMAINS A SERIOUS PROBLEM FOR MANY OF OUR TRADING PARTNERS.

EVEN OUR MORE AFFLUENT ALLIES ARE HARD PRESSED TO AFFORD THE UP-TO-DATE MILITARY SYSTEMS AND HARDWARE. THE TREND IN FIGHTER AIRCRAFT HAS BEEN TOWARD INCREASINGLY MORE CAPABLE, VERSATILE AND TECHNICALLY SOPHISTICATED

AIRCRAFT. THE UNITED STATES UNQUESTIONABLY PRODUCES THE FINEST FIGHTER AIRCRAFT SYSTEMS IN THE WORLD TODAY. BUT QUALITY DOES NOT COME CHEAP, AND THESE AIRCRAFT ARE EXPENSIVE. THE FACT THAT THEY ARE WELL WORTH THE MONEY DOES NOT CHANGE THE FACT THAT PURCHASING NATIONS FACE MAJOR PROBLEMS IN COMING UP WITH THE MONEY TO PAY FOR THEM.

FROM THE U.S. POINT OF VIEW, THIS PROBLEM IS AGGRAVATED BY ANOTHER KEY EMERGING FACTOR: INCREASED COMPETITION. FOR DECADES THE U.S. ENJOYED A VIRTUAL MONOPOLY IN FREE WORLD MILITARY EXPORT MARKET. OUR PRODUCTS WERE AND REMAIN SUPERIOR, AND OUR ECONOMIES OF SCALE PROVIDE US WITH A DISTINCT PRICE ADVANTAGE. WHILE OUR PRODUCTS REMAIN SUPERIOR, THERE ARE MANY MORE SERIOUS COMPETITORS THAN PREVIOUSLY. CONSEQUENTLY, BUYERS HAVE INCREASED LEVERAGE AND OFFSETS HAVE BECOME AN INCREASINGLY IMPORTANT FACTOR IN MAKING MILITARY EXPORT AND OTHER SALES. IN MANY CASES, U.S. COMPANIES ARE FACED WITH A CHOICE BETWEEN ACCEPTING LESS THAN OPTIMUM AGREEMENTS WHICH INCORPORATE OFFSETS, OR LOSING SALES.

THERE IS NO ARGUING THE FACT THAT OFFSETS, LIKE ALL FORMS OF BARTER TRADE, ARE TO SOME EXTENT ECONOMICALLY INEFFICIENT. IT IS IMPORTANT TO REMEMBER, HOWEVER, THAT THEY MAY BE INEFFICIENT FOR BUYER AND SELLER ALIKE. THE U.S. IS COMMITTED TO MAKING TRADE WITH OUR NATO PARTNERS A "TWO-WAY STREET". LIKE ALL MAJOR CHANGES TO TRADE POLICY, THIS COMMITMENT CAN INVOLVE BOTH COSTS AND BENEFITS. THIS IS PARTICULARLY TRUE OF MILITARY EXPORT SALES. THE ESTABLISHMENT OF EXPANDED

COPRODUCTION, WILL, IN ALL PROBABILITY, INVOLVE SIGNIFICANT TRANSITION COSTS, AND WILL HAVE SOME IMPACT ON OUR DEFENSE BASE. THE POINT TO BE MADE IS THAT OFFSETS ARE COMPLEX AND SHOULD BE STUDIED CAREFULLY. IN WEIGHING THESE COSTS AND BENEFITS, THE ROLE OF OFFSETS IN ATTAINING OUR FOREIGN POLICY AND NATIONAL SECURITY OBJECTIVES SHOULD BE CAREFULLY CONSIDERED.

THE DEPARTMENT OF COMMERCE IS CURRENTLY STUDYING THE IMPACTS OF OFFSETS ON U.S. INDUSTRIAL COMPETITIVENESS. OUR ANALYSIS IS STILL UNDERWAY. WE HAVE MADE SUBSTANTIAL PROGRESS AND HAVE BEGUN TO ANALYZE DATA THAT CAUSE CONCERN, PARTICULARLY IN THE AREA OF MILITARY OFFSETS. WHILE WE ARE ADVISED THAT OFFSETS ARE A NECESSARY AND POSITIVE COMPONENT OF ARMING OUR ALLIES, WE FEEL THERE ARE SOME POTENTIAL ECONOMIC EFFECTS OF THE PRACTICE THAT WARRANT CLOSE SCRUTINY. THESE INCLUDE:

- THE POTENTIAL ECONOMIC IMPACTS OF OFFSETS ON OUR DEFENSE INFRASTRUCTURE, PARTICULARLY SECOND AND THIRD TIER SUBCONTRACTORS;

- THE POTENTIAL EROSION OF U.S. COMPETITIVENESS IN NONDEFENSE SECTORS AS A RESULT OF INDIRECT TECHNOLOGY TRANSFERS AND COUNTERTRADE ASSOCIATED WITH MILITARY OFFSET AGREEMENTS;

- THE FACT THAT COPRODUCTION CAN IN SOME CASES INCREASE THE UNIT COST OF SOME COMPONENTS OF U.S. WEAPONS SYSTEMS;

- THE THREAT THAT OFFSET AGREEMENTS HAVE THE EFFECT OF CREATING COMPETITORS IN THE ARMS EXPORT MARKET;

- THE GROWING "SPILL-OVER" EFFECT OF MILITARY OFFSETS INTO NON-MILITARY TRADE.

THESE CONCERNS HIGHLIGHT THE REAL CHALLENGE THAT WE FACE IN UNDERSTANDING THE ISSUE OF OFFSETS AND OTHER FORMS OF COUNTERTRADE. THESE FORMS OF TRADE ARE AN ECONOMIC FACT OF LIFE IN THE INTERNATIONAL MARKET PLACE. EACH YEAR THE WORLD ECONOMY BECOMES A SMALLER PLACE AS COMPETITION FOR EXPORT MARKETS INTENSIFIES. IN VIEW OF THESE TRENDS, IT IS CLEAR THAT THERE IS A NEED FOR US TO BE FLEXIBLE AND OPEN HANDED IN OUR ANALYSIS OF THE ROLE OF OFFSETS IN THE INTERNATIONAL MARKET PLACE.

- WE ARE CURRENTLY SEEKING A MULTILATERAL CONSENSUS ON COUNTERTRADE ISSUES, AND IMPROVED INFORMATION ON WHICH TO BASE POLICY DEVELOPMENT DECISIONS. THE FOCUS OF OUR RECENT EFFORTS WAS TO WORK WITH THE PARIS BASED ORGANIZATION FOR ECONOMIC COOPERATION AND DEVELOPMENT TO PRODUCE A MAJOR REPORT ON COUNTERTRADE WITH DEVELOPING NATIONS. THIS GREATLY IMPROVED OUR UNDERSTANDING OF THE NEEDS AND ISSUES INVOLVED. THIS WAS AN INITIAL EFFORT TO ASSESS USE OF COUNTERTRADE BY DEVELOPING NATIONS AND PARALLELS A SIMILAR EFFORT ANALYZING EAST-WEST COUNTERTRADE.

- AT THE INITIATIVE OF THE UNITED STATES GOVERNMENT, A STUDY WAS PREPARED BY THE GATT SECRETARIAT ON COUNTERTRADE. THE STUDY REVIEWED THE ROLE OF COUNTERTRADE IN MEETING GATT POLICY OBJECTIVES, AND PROVIDED AN ASSESSMENT OF THE IMPACT OF COUNTERTRADE ON WORLD TRADE.

- THE UNITED STATES TRADE REPRESENTATIVE, WITH SUPPORT FROM DEFENSE, TREASURY, STATE AND COMMERCE, HAS INITIATED DISCUSSIONS WITH OUR MAJOR ARMS PRODUCING ALLIES TO INVESTIGATE THE RELATIVE IMPORTANCE OF OFFSETS AS PERCEIVED BY PURCHASING NATIONS. THE RESULTS OF THESE DISCUSSIONS WILL BE PRESENTED AS A SECTION OF THE DPA OFFSET REPORT THAT WILL BE SUBMITTED TO THIS COMMITTEE.

THESE ARE SOME OF THE STEPS THAT ARE BEING TAKEN TO DEVELOP AN UNDERSTANDING OF THE IMPACTS OF OFFSETS AND COUNTERTRADE. THE OBJECTIVE OF THIS EFFORT, LIKE THIS MEETING TODAY, IS TO INSURE THAT OFFSETS AND COUNTERTRADE ARE PROPERLY UNDERSTOOD, AND THAT THE ECONOMIC, FOREIGN POLICY AND NATIONAL SECURITY NEEDS OF THE UNITED STATES ARE SERVED TO THE MAXIMUM EXTENT POSSIBLE.

Chairman **LaFalce**. Thank you, Mr. Olson. We will hold our questions until we hear from the other panelists.

We will now hear from Mr. James Blaker, Deputy Assistant Secretary of Defense for Policy ~~Analysis~~.

STATEMENT OF JAMES R. BLAKER, DEPUTY ASSISTANT SECRETARY FOR POLICY ANALYSIS, DEPARTMENT OF DEFENSE, ACCOMPANIED BY COL. WILLIAM WEIDA, DIRECTOR, INTERNATIONAL ECONOMICS AND ENERGY AFFAIRS

Mr. **Blaker**. Thank you, Mr. Chairman. I will be brief and I will try to just summarize some of the statement. But I would like to introduce William Weida—to my left, your right. Bill is the real expert in this and if you will permit me when we deal with technical questions——

Chairman **LaFalce**. What is his last name?

Mr. **Blaker**. Weida.

Chairman **LaFalce**. How do you spell it?

Mr. **Blaker**. W-e-i-d-a.

If you will permit me, I think he is probably best qualified to answer technical questions.

I will just comment briefly on the utility of arms transfers in general and how we believe offsets fit into this framework. As you know, we pursue at least five general objectives with arms transfers.

We believe that they deter aggression by enhancing the defense preparedness of our allies and friends. We believe that they increase the ability of the United States to project power. That is that power projection capabilities are enhanced by arms transfers when such transfers are agreed to in whole or in part in consideration for the granting of basing or access rights for U.S. forces on foreign soil.

Just as background I might point out that if you were to compare the global basing structure of the United States with that of 20 years ago, you would discover that whereas 20 years ago we had roughly 700 bases worldwide, we now operate our forces from half that number, about 335.

Basing is very important to us, particularly given the types of threats which we face.

We believe that arms transfers support interoperability with the forces of friends and allies. That is, that they enhance our combined effort to provide defense. They enhance arms transfers, enhance U.S. defense production capability and efficiency, and they strengthen the collective security arrangements of our allied structure.

I might comment briefly on that last one. To the extent that our allies see mutually beneficial arms transfers, their governments are in a better position to maintain public support for the alliance. This is an important, subtle, and increasingly difficult problem in particular with NATO.

You are acquainted with the historical background of this general problem. The original rationale for offset programs was the desire of arms buyers to create a national defense industrial base, acquire modern technology and management techniques, and solve the balance-of-payment problem.

It was also clearly in the interest of the United States to aid this process because it bolstered the defenses of both ourselves and our allies. Coproduction of U.S. equipment had begun by the early 1960's and in the years which followed, an increasing number of significant coproduction programs were undertaken within NATO, with Japan, Korea, and Taiwan.

All of these programs benefited both the United States and the purchasers of weapons through some increase in sales of U.S. systems, enhanced standardization, second source establishment, modernization of allied forces and increased U.S. ties to the coproducing nations.

From the military purchaser's perspective, however, the cost of systems was sometimes increased. And since no foreign systems were being procured or coproduced in the United States, the process seemed quite one-sided from the viewpoint of weapons purchasers.

In 1975, the United States and Swiss Governments signed a Memorandum of Understanding guaranteeing 30 percent combined government and industry offset on Switzerland's purchase of 72 F-5 aircraft.

This was a significant deal because of what it meant. Since Switzerland did not choose to undertake large-scale coproduction of the F-5, they used this purchase to get additional offsets outside of coproduction. Intense Swiss pressure to fulfill the goals of this arrangement created a number of fundamental problems for the Department of Defense.

Under the arrangements that had existed up until that time, the Department of Defense played a much more active role in offsets than it does now. In this situation, the Department was placed in the strange position of trying to help market Swiss-produced electrical generators in effect being in competition with American producers.

The Department of Defense did not like this. It is not the business of the Department of Defense to do that and, as a result of that, we tried to change it.

The reluctance of the Department of Defense to assume these kinds of commitments led to a policy established by then Deputy Secretary of Defense Duncan in the 1978 memorandum. This document stated that the Department of Defense would not normally obligate itself to satisfy commitments for offsets or for compensatory coproduction. Since that time, the responsibility for negotiating and meeting offsets has rested on the commercial firms making the sales.

The Department of Defense, as an element of the U.S. Government, has established a position of neither supporting nor guaranteeing the fulfillment of offsets. At the same time, we in the Department recognize that offsets are frequently necessary to win overseas weapons sales, and that there may be a valid strategic reason for supporting offset activities among our allies.

In the testimony that we have submitted for the record, I have tried to lay out in much greater detail the policy basis for the Department's views.

Now, as you also know, as we have been involved in this kind of an activity, the cumulative effect of years of programs designed to build foreign defense industrial bases has expanded the number of arms exporters and increased import competition. This expanded number of exporters has increased competitions in the arms market, and this in turn has added the further impetus to the move toward more and larger offsets.

However, even with the increased use of offsets, it must be remembered that no one has forced U.S. industry to participate in offset deals. These decisions have been made by our private sector after a close examination of the potential costs and benefits involved. And the many benefits to the U.S. production base associated with foreign military sales—even after offsets—are taken into consideration and have been noted by the Congressional Budget Office.

I will conclude. The effect of coproduction and offsets is often quite beneficial in pursuit of the national objective of the United States. Offsets can help improve standardization and interoperability of our forces with those of our allies. Cooperative weapon construction programs give our major alliance partners the necessary defense base to provide an equitable share of the defense of the alliance to which all are members.

NATO countries have the infrastructure necessary to absorb offsets and, as a result, the impact of offsets toward achieving our national goals is felt to the largest extent within NATO.

It is sometimes helpful to note that the United States has maintained a policy of establishing domestic production capabilities for any major weapon system it purchases overseas. This policy has been used to keep our industrial base capable of supporting the weapons we use. But the practical effect of this rule is that the United States essentially creates a 100-percent offset on any major weapon system it purchases overseas.

In addition, the two-way flow of trade stemming in part from direct offsets has been used to build a base in foreign nations which is often capable of sustaining the projection of U.S. power.

These benefits of offsets must be balanced against the economic consequences of offset deals and against potential industrial base erosion arising from offsets.

A decision made in 1978 has left the economic consequences of offsets in the hands of private enterprise. Deciding whether this was a wise decision is essentially a two-part problem, two-step solution.

First, it must be shown that these offsets have caused a problem which has seriously affected the defense industrial base.

Second, if a problem is discovered, it must be demonstrated that some other form of control of offsets instead of the private-sector approach which now dominates would do more to solve the problem.

Everyone recognizes that offsets can have both positive and negative effects. In the defense arena, the major negative effect may be the loss of subcontractor work through the granting of offsets for overseas production. However, this potential loss must be weighed against the benefits of being able to sell the weapons in the first place and against the alliance and foreign policy objectives which offsets fulfill.

Mr. Chairman, let me just end by saying that the work of your committee, and in particular the mandating of this report, has probably been one of the most important steps in trying to get a grip on this problem. The work that is underway on that report has solidified our understanding of it and, quite frankly, we are very grateful for your action.

The report that you will get in October, I think, will be the best systematic overview of the problem. It will advance understanding not just in the executive branch, but outside more than any single event.

Thank you.

[The prepared statement of Mr. Blaker follows:]

DEPARTMENT OF DEFENSE

STATEMENT OF
DEPUTY ASSISTANT SECRETARY OF DEFENSE,
POLICY ANALYSIS
ON

THE IMPACT OF OFFSETS

BEFORE

THE SUBCOMMITTEE ON ECONOMIC STABILIZATION OF
THE HOUSE COMMITTEE ON BANKING, FINANCE, AND URBAN AFFAIRS

JULY 24, 1985

JAMES R. BLAKER

DEPUTY ASSISTANT SECRETARY

Thank you, Mr. Chairman, for the opportunity to discuss the important topic you have focused on in today's hearing. From the standpoint of most governments, arms transfers are a principal tool for the conduct of foreign policy. For the United States, this is reflected in the Arms Export Control Act, which provides a legal framework within which arms transfers can be made, and in formal executive branch policy statements which identify the foreign policy objectives to be pursued with arms transfers.

Offsets in Defense Trade: the Foreign Policy Context

Before one can discuss policy concerning offsets, the foreign policy objectives traditionally pursued through arms transfers and the influence of offsets on these objectives must be understood. For the United States these include:

A. Deter aggression by enhancing the preparedness of allies and friends:

In most cases offsets do not affect specific aspects of preparedness significantly. However, in a broad sense, offsets can reduce the efficient use of the total resources available for enhancing preparedness.

B. Increase the ability of the U.S. to project power:

Power projection capabilities are enhanced by arms transfers when such transfers are agreed to in whole or in part in

CONSIDERATION FOR THE GRANTING OF BASING OR ACCESS RIGHTS FOR U.S. FORCES ON FOREIGN SOIL. OFFSET ARRANGEMENTS HAVE NO DIRECT BEARING ON THIS OBJECTIVE. BUT TO THE EXTENT THAT ACCEPTANCE OF OFFSETS IS A CONDITION WITHOUT WHICH THE TRANSFER WOULD NOT TAKE PLACE, (AND WITHOUT WHICH ADVANTAGES EXTRANEOUS TO THE SALE ITSELF, SUCH AS BASE OR ACCESS RIGHTS WOULD NOT BE GRANTED), OFFSETS CAN HAVE AN INDIRECT BEARING ON U.S. POWER PROJECTION CAPABILITIES.

C. SUPPORT INTEROPERABILITY WITH THE FORCES OF FRIENDS AND ALLIES:

AGAIN, THE DIRECT EFFECT OF OFFSETS IS NEGLIGIBLE. BUT TO THE EXTENT THAT ACCEPTANCE OF OFFSETS IS A CONDITION OF SALE, AND THAT IN THE ABSENCE OF A U.S. SALE THE CUSTOMER WOULD ACQUIRE EQUIPMENT FROM ANOTHER SUPPLIER WHICH WOULD NOT BE INTEROPERABLE WITH U.S. EQUIPMENT, OFFSETS CAN HAVE A POSITIVE INDIRECT EFFECT.

D. ENHANCE U.S. DEFENSE PRODUCTION CAPABILITY AND EFFICIENCY:

HERE THE DIRECT AND INDIRECT EFFECTS OF OFFSETS ARE REVERSED. TO THE EXTENT THAT OFFSETS INVOLVE THE TRANSFER OF PRODUCTION TO FOREIGN CUSTOMERS THAT WOULD OTHERWISE HAVE TAKEN PLACE IN THE U.S., PRODUCTION CAPABILITY AND EFFICIENCY MAY BE REDUCED. BUT IF A SALE WOULD NOT HAVE TAKEN PLACE UNLESS OFFSETS WERE ACCEPTED, IT CAN BE ARGUED

THAT OFFSETS SUPPORT THIS OBJECTIVE SINCE THEY ALLOW SOME U.S. DEFENSE PRODUCTION TO TAKE PLACE.

E. STRENGTHEN COLLECTIVE SECURITY ARRANGEMENTS:
OFFSETS CAN ENHANCE COLLECTIVE SECURITY ARRANGEMENTS BY MAKING CUSTOMER GOVERNMENTS BETTER ABLE TO DEFEND SUCH ARRANGEMENTS ON GROUNDS OTHER THAN SECURITY ALONE. FOR EXAMPLE, OUR NATO PARTNERS' CONTINUING CONCERN ABOUT THE BALANCE OF DEFENSE TRADE HAS GIVEN RISE TO THE CONCEPT OF THE TWO-WAY STREET, I.E. A CONCERTED EFFORT ON THE PART OF THE U.S. TO PURCHASE DEFENSE EQUIPMENT FROM OUR NATO PARTNERS. TO THE EXTENT THAT OFFSETS LEAD TO INCREASED DEFENSE PRODUCTION IN OTHER NATO COUNTRIES, THEY HAVE THE SAME EFFECT AS U.S. PURCHASES OF FOREIGN MANUFACTURED DEFENSE GOODS. IN EITHER CASE, FOREIGN GOVERNMENT LEADERS ARE BETTER ABLE TO ASSERT THAT THE ALLIANCE IS TRULY MUTUALLY BENEFICIAL.

U.S. POLICY ON OFFSETS

HISTORICAL BACKGROUND

ALTHOUGH THE CONCEPTS WHICH UNDERLIE OFFSET AGREEMENTS ARE AS OLD AS BARTER ITSELF, ACTUAL PRODUCTION OF U. S. WEAPON SYSTEMS IN FOREIGN COUNTRIES BEGAN IN EUROPE AND JAPAN IN THE

LATE 1950'S. THE ORIGINAL RATIONALE FOR THESE PROGRAMS WAS THE DESIRE OF ARMS BUYERS TO CREATE A NATIONAL DEFENSE INDUSTRIAL BASE, ACQUIRE MODERN TECHNOLOGY AND MANAGEMENT TECHNIQUES, AND SOLVE BALANCE OF PAYMENT PROBLEMS. IT WAS ALSO CLEARLY IN THE INTEREST OF THE UNITED STATES TO AID THIS PROCESS BECAUSE IT BOLSTERED THE DEFENSES OF BOTH OURSELVES AND OUR ALLIES, IMPROVED OUR ALLIES' INDUSTRIAL CAPABILITY, AND STRENGTHENED THEIR ECONOMIES. HOWEVER, AS A DEPARTMENT OF DEFENSE TASK GROUP FOUND IN 1983, "WITH SOME OF THE CONCOMITANT EFFECTS SUCH AS INCREASED COMPETITIVENESS ON THE PART OF EUROPEAN AND JAPANESE INDUSTRY, THESE PROGRAMS ARE [NOW] OFTEN A CHALLENGE TO US INTERESTS."[1]

COPRODUCTION OF U.S. EQUIPMENT HAD BEGUN BY THE EARLY 1960'S, AND IN THE YEARS WHICH FOLLOWED AN INCREASING NUMBER OF SIGNIFICANT COPRODUCTION PROGRAMS WERE UNDERTAKEN WITHIN NATO, AND WITH JAPAN, KOREA, AND TAIWAN.* THE LARGEST PROGRAM, THE PURCHASE OF THE F-16 BY NORWAY, DENMARK, BELGIUM, AND THE NETHERLANDS FOR $2.8 BILLION (IN 1975 DOLLARS) INVOLVED THESE COUNTRIES IN THE PRODUCTION OF 10 PERCENT OF THE VALUE OF THE INITIAL US AIRCRAFT, 15 PERCENT OF THE VALUE OF ALL THIRD COUNTRY AIRCRAFT, AND 40 PERCENT OF THE VALUE OF THEIR OWN aircraft. They are also guaranteed a minimum offset level of 58 percent of their initial purchase, and the US government is committed to seeking a 100 percent offset by using third country sales aircraft and other offset work of comparable technology.[2]

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* For example, some of these programs were: Italy/Tracked Vehicles, 1963-65, $225 Million; Germany/Helicopters, 1965-68, $540 Million; Spain/DEG Ships, 1964, $300 Million; NATO/LAW, 1964, $30 Million; Italy/F104S, 1965, $640 Million, UK/F-4, 1964, $700 Million; Japan/HAWK and NIKE, 1967, $20 Million; NATO/Seasparrow, 1968, $40 Million; NATO/SIDEWINDER, 1968, $36 Million; Japan/F-4, 1969, $700 Million; Korea/M16 Rifle, Ammo, 1971-72, $155 Million; ROC/F-5E, 1973, $230 Million.

Recent programs have benefited both the United States and the purchasers of the weapons through increased sales of US systems, enhanced standardization, second-source establishment, modernization of Allied forces, and increased US ties to the co-producing nations. From the foreign purchaser's perspective, however, the cost of systems was increased. Significant work orders were hard to get because the purchaser's industry was only competitive with US sources in some cases, and since no foreign systems were being procured or co-produced in the United States, the process seemed quite one-sided from the viewpoint of the weapon purchasers.[3]

Changing Offset Requirements

The many drawbacks to the purchaser inherent in the offset programs just described led the European nations to require offsets on procurements from the United States and other nations which were in addition to the coproduction of systems for their own forces. These offsets, which were either direct (related to the production of the weapon being purchased) or indirect (related to other products), were used to relieve the economic problems associated with weapon procurement. These new programs took the form of R&D, technology transfer, production work which led to job creation and import substitution, and codevelopment projects where both the Europeans and the United States jointly defined system requirements and jointly performed system engineering with eventual arrangements for production in both the US and Europe. The result was a greatly increased level of involvement of European engineering and research in the definition of Europe's own armed forces.[4]

In 1975, the U.S. and Swiss governments signed a Memorandum of Understanding (MOU) guaranteeing 30 percent combined government and industry offset on Switzerland's purchase of 72 F-5 aircraft for $400 million. Since Switzerland did no choose to undertake large scale coproduction of the F-5, they used this purchase to get additional offsets outside of coproduction. Intense Swiss pressure to fullfill the goals of this program, and the difficulties which the U.S. government experienced in administering it were both representative of the trend toward growing demands by nations for defense offsets. These demands, and the reluctance of the DoD to assume any further commitment, led to a policy established by then Deputy Secretary of Defense Duncan in a 1978 memorandum. This document stated that the Department of Defense would not normally obligate itself to satisfy commitments for offsets or for compensatory coproduction. Since that time, the responsibility for negotiating and meeting offsets has rested solely on the commercial firms making the sales.[5]

The period from 1975 to the present has been marked by a number of offset deals which strongly served U.S. security

INTERESTS BUT WHICH, DUE TO THE INCREASING AMOUNTS OF OFFSETS DEMANDED, HAVE BEEN THE CAUSE OF CONSIDERABLE CONCERN. IN ADDITION, THE FORM OF WEAPON PROCUREMENT DEALS HAS BEGUN TO CHANGE. PROGRAMS INVOLVING VARYING DEGREES OF EUROPEAN PARTICIPATION WITH THE U.S. IN THE DEVELOPMENT OF WEAPONS HAVE BEEN STARTED AND AN INCREASED USE OF LICENSED PRODUCTION COUPLED WITH A GROWING INTEREST IN CODEVELOPMENT (WHERE TWO NATIONS JOINTLY PERFORM R&D FOR A SYSTEM) HAVE BEEN NOTED.[6] THESE EFFORTS HAVE DAMPENED THE DEMAND FOR TRADITIONAL (MANDATORY) OFFSETS IN NATO AND THEY ARE LEADING TO MORE COOPERATIVE ATTITUDES REGARDING ARMS PRODUCTION.

INCREASING COMPETITION

AS MIGHT BE EXPECTED, THE CUMULATIVE EFFECT OF YEARS OF PROGRAMS DESIGNED TO BUILD FOREIGN DEFENSE INDUSTRIAL BASES HAS EXPANDED THE NUMBER OF ARMS EXPORTERS AND INCREASED IMPORT COMPETITION. THERE ARE TWO TYPES OF EXPORTERS: THE "INDUSTRIAL BASE' NATIONS WHICH MANUFACTURE WEAPONS FOR EXPORT, AND THE "SUBTERRANEAN MARKET" COUNTRIES WHICH SELL USED ARMS TO OTHER COUNTRIES. THIS EXPANDED NUMBER OF EXPORTERS HAS INCREASED COMPETITION IN THE ARMS MARKET, AND THIS, IN TURN, HAS ADDED FURTHER IMPETUS TO THE MOVE TOWARD MORE AND LARGER OFFSETS. WEAPONS CONTINUE TO BE SOLD BASED ON A TOTAL PACKAGE OF PRICE/PERFORMANCE/SCHEDULE/INDUSTRIAL PARTICIPATION/ OFFSETS, BUT THE WORLD ECONOMIC SITUATION, PARTICULARLY SINCE 1980, HAS GIVEN FAR MORE IMPORTANCE TO THE LAST TWO CATEGORIES.[7]

However, even with the increased use of offsets, it must be remembered that no one has forced U.S. industry to participate in offset deals. These decisions have been made by our private sector after a close examination of the potential costs and benefits involved, and the many benefits to the U.S. production base associated with foreign military sales, even after offsets are taken into consideration, have been affirmed by the Congressional Budget Office.

Specific U. S. Government Guidance on Offsets

1978 Duncan Memorandum

In brief, this memorandum established the following guidance:

1. "Because of the inherent difficulties in negotiating and implementing compensatory coproduction and offset agreements, and the economic inefficiencies they often entail, DoD shall not normally enter into such agreements."[8]

2. "An exception will be made only when there is no feasible alternative to ensure the successful completion of transactions considered to be of significant importance to United States national security interests."[9]

3. WHEN COMPENSATORY AGREEMENTS ARE NECESSARY:

A. THEY SHOULD BE AS BROAD AS POSSIBLE TO OBTAIN MAXIMUM CREDIT FOR U.S. PURCHASES.

B. SPECIFIC OFFSET TARGETS SHOULD BE AVOIDED.

C. AGREEMENTS SHOULD BE USED TO REDUCE ADMINISTRATIVE BARRIERS TO DEFENSE TRADE.

D. ..."THE BURDEN OF FULFILLING ANY COMMITMENT RESTS WITH THE U.S. DEFENSE FIRMS DIRECTLY BENEFITING FROM THE SALE."[10]

ARMS EXPORT AND CONTROL ACT (AECA) AND DEFENSE SECURITY ASSISTANCE AGENCY (DSAA) GUIDELINES ON FOREIGN MILITARY SALES CREDIT

THE INTENT OF THE CONGRESS IS THAT APPROPRIATED FUNDS BE SPENT IN THE U.S. UNLESS SPECIFIC EXCEPTION IS APPROVED. THE DEFENSE SECURITY ASSISTANCE AGENCY (DSAA), WHICH CONTROLS AND MANAGES THE FMS ACCOUNTS HAS THEREFORE ESTABLISHED A POLICY WHICH IS REFLECTED IN OFFSET GUIDELINES WHICH ARE VERY STRINGENT. A SIGNIFICANT PORTION OF ANY ITEM WHICH IS SOLD THROUGH A FOREIGN MILITARY SALES (FMS) CREDIT (LOAN OR GRANT) PROGRAM MUST BE OF U.S. ORIGIN UNLESS OTHERWISE APPROVED BY DSAA

ON THE BASIS OF CAREFULLY PROSCRIBED CIRCUMSTANCES. ANY SUCH DETERMINATION REQUIRES INTERAGENCY REVIEW BEFORE DOD PROCEEDS. THOSE PARTS OF THE FMS CREDIT GUIDELINES WHICH CONCERN OFFSETS ARE SUMMARIZED BELOW:

1. "CREDIT FINANCING IS DISCOURAGED FOR PURCHASES CONTAINING OFFSET PROVISIONS AS A CONDITION FOR SECURING THE PURCHASE."[11]

2. "NO FMS CREDIT FUNDS WILL BE AUTHORIZED OR DISBURSED TO PAY FOR MANDATORY DIRECT OFFSETS."[12]

3. "WHILE FMS CREDIT FUNDS WILL NOT BE AUTHORIZED FOR FOREIGN PRODUCED CONTENT RESULTING FROM MANDATORY DIRECT OFFSET, SUCH FUNDING CAN BE AUTHORIZED FOR THE U.S. CONTENT."[13]

4. "SECTION 42(B) OF THE AECA [ARMS EXPORT CONTROL ACT] PRESCRIBES THAT DIRECT CREDITS AND GUARANTEED-LOANS MAY NOT BE USED TO FINANCE COPRODUCTION OR LICENSED PRODUCTION OF ANY DEFENSE ARTICLE OF U.S. ORIGIN OUTSIDE THE UNITED STATES UNLESS THE SECRETARY OF STATE NOTIFIES THE CONGRESS IN ADVANCE OF THE [EFFECTS OF THE] PROPOSED TRANSACTION ON EMPLOYMENT AND PRODUCTION WITHIN THE UNITED STATES."[14]

Major Tenets of the
Overall U.S. Government Policy

In addition to the specific rules governing the Department of Defense and its approach to offsets, there are a set of more general tenets of U.S. policy which are relevant to the offset issue:

1. For all friendly nations, we encourage stronger defense forces, improved U.S. ties and influence, and enhanced standardization and interoperability with U.S. forces.

2. We desire to implement standardization and interoperability to the maximum extent possible with Japan, NATO, New Zealand, and Australia.

3. We want to maintain a technologically advanced and economically viable defense industrial base within NATO.

4. We want to help selected nations improve their defense industrial bases and economies through collaborative defense programs.

5. We will encourage two-way defense trade and collaborative development activities.

6. U.S. ARMS WILL BE TRANSFERRED JUDICIOUSLY, WITH U.S. CONTROL AND DIRECTION, TO FURTHER U.S. INTERESTS.

7. WE WILL APPROVE COPRODUCTION OR TRANSFER OF SENSITIVE ADVANCED TECHNOLOGY ONLY AFTER CAREFUL SCRUTINY.[15]

8. THE U.S. GOVERNMENT REMAINS OPPOSED TO ANY FORM OF MANDATORY OFFSET REQUIREMENTS ON THE PART OF FOREIGN GOVERNMENTS AND TO THE IMPOSITION OF UNILATERAL OFFSET RESTRICTIONS ON OUR OWN INDUSTRIES.

IN SUM, THE DEPARTMENT OF DEFENSE, AS AN ELEMENT OF THE UNITED STATES GOVERNMENT, HAS ESTABLISHED A POSITION OF NEITHER SUPPORTING NOR GUARANTEEING THE FULFILLMENT OF OFFSETS. HOWEVER, IT IS RECOGNIZED THAT OFFSETS ARE FREQUENTLY NECESSARY TO WIN OVERSEAS WEAPON SALES, AND THAT THERE MAY BE VALID STRATEGIC REASONS FOR SUPPORTING OFFSET ACTIVITIES AMONG OUR ALLIES.

EXCEPTIONS TO U.S. POLICY ON OFFSETS

THERE ARE TWO CLASSES OF EXCEPTIONS TO THE OFFSET POLICIES LAID OUT IN THE PREVIOUS PARAGRAPHS. THE FIRST CONCERNS THOSE COUNTRIES WHICH HAD OFFSET AGREEMENTS ALREADY IN FORCE AT THE TIME THE DUNCAN MEMORANDUM WAS ACCEPTED. U.S. GOVERNMENT GUARANTEES WERE SOMETIMES INVOLVED IN THESE AGREEMENTS, AND THOSE GUARANTEES CONTINUE TO BE HONORED AFTER GOVERNMENT POLICY

CHANGED. THE MOST NOTABLE PROGRAMS IN WHICH THIS OCCURRED WERE THOSE INVOLVING THE SWISS PURCHASE OF THE F-5, THE COPRODUCTION PROGRAM INVOLVING THE F-16 AND OUR NATO ALLIES, AND THE AUSTRALIAN PROGRAM WHICH INVOLVED THE PURCHASE OF SHIPS AND OTHER DEFENSE EQUIPMENT. OF THESE, THE AUSTRALIAN PROGRAM HAS BEEN THE LARGEST AND THE MOST COMPLEX.

THE SECOND CLASS OF EXCEPTIONS INVOLVES AN OUTRIGHT WAIVER OF THE RULES AFTER THEY WERE ADOPTED, AND THIS HAS HAPPENED IN ONLY ONE CASE. ISRAEL HAS CONSISTENTLY SOUGHT TO USE ITS FMS FUNDS TO PROVIDE OFFSETS. PRIOR TO 1984, THESE EFFORTS WERE OPPOSED BY THE ADMINISTRATION AND WERE ONLY MINIMALLY SUCCESSFUL. BUT, IN 1984, ISRAEL WAS ALLOWED BY THE ADMINISTRATION TO TAKE OFFSETS ON UP TO 15 PERCENT OF THE TOTAL VALUE OF ISRAELI PURCHASES. THIS GAVE THE ISRAELIS ABOUT $225 MILLION IN OFFSETS. IN 1985, ISRAEL WAS ALLOWED TO TAKE $200 MILLION IN OFFSETS, AGAIN BASED ON AN AGREEMENT WITH THE ADMINISTRATION.

CONCLUSION

COPRODUCTION AND OTHER OFFSETS ARE IMPORTANT INSTRUMENTS TO BE USED, ALONG WITH OTHER ELEMENTS OF FOREIGN POLICY, IN PURSUIT OF THE NATIONAL OBJECTIVES OF THE UNITED STATES. THE USE OF OFFSETS IS A MAJOR ELEMENT OF OUR POLICY TO IMPROVE RELIABILITY, STANDARDIZATION AND INTEROPERABILITY OF OUR FORCES WITH THOSE OF OUR ALLIES. COOPERATIVE WEAPON CONSTRUCTION PROGRAMS GIVE OUR MAJOR ALLIANCE PARTNERS THE NECESSARY DEFENSE BASE TO PROVIDE AN

EQUITABLE SHARE OF THE DEFENSE OF THE ALLIANCE TO WHICH ALL ARE MEMBERS.

MOST INDIRECT OFFSETS OCCUR IN NON-NATO COUNTRIES WHILE MOST COOPERATIVE EFFORTS AND DIRECT OFFSETS OCCUR IN THE NATO REGION. NATO COUNTRIES HAVE THE INFRASTRUCTURE NECESSARY TO ABSORB OFFSETS AND AS A RESULT, THE IMPACT OF OFFSETS TOWARD ACHIEVING OUR NATIONAL GOALS IS FELT TO THE LARGEST EXTENT WITHIN NATO.

CONCURRENT WITH THIS, THE UNITED STATES HAS MAINTAINED A POLICY OF ESTABLISHING DOMESTIC PRODUCTION CAPABILITIES FOR ANY MAJOR WEAPON SYSTEM IT PURCHASES OVERSEAS. THIS POLICY HAS BEEN USED TO KEEP OUR INDUSTRIAL BASE CAPABLE OF SUPPORTING THE WEAPONS WE USE, BUT THE PRACTICAL EFFECT OF THIS RULE IS THAT THE UNITED STATES ESSENTIALLY CREATES A 100 PERCENT OFFSET ON ANY MAJOR WEAPON SYSTEM IT PURCHASES OVERSEAS. IN ADDITION, THE TWO-WAY FLOW OF TRADE STEMMING, IN PART, FROM DIRECT OFFSETS HAS BEEN USED TO BUILD A BASE IN FOREIGN NATIONS WHICH IS OFTEN CAPABLE OF SUSTAINING THE PROJECTION OF U.S. POWER.

THESE BENEFITS MUST BE BALANCED AGAINST THE ECONOMIC CONSEQUENCES OF OFFSET DEALS AND AGAINST POTENTIAL INDUSTRIAL BASE EROSION ARISING FROM OFFSETS. WHILE THE U.S. GOVERNMENT HAS BEEN CAREFUL TO MONITOR THE HEALTH OF THE DEFENSE INDUSTRIAL BASE, A DECISION MADE IN 1978 HAS LEFT THE ECONOMIC CONSEQUENCES OF OFFSETS IN THE HANDS OF PRIVATE ENTERPRISE. DECIDING WHETHER THIS WAS A WISE DECISION IS ESSENTIALLY A TWO-PART PROBLEM. FIRST, IT MUST BE SHOWN THAT THESE OFFSETS HAVE CAUSED A PROBLEM WHICH HAS SERIOUSLY AFFECTED THE DEFENSE INDUSTRIAL BASE. AND SECOND, IF A PROBLEM IS DISCOVERED, IT MUST BE DEMONSTRATED THAT

SOME OTHER FORM OF CONTROL OF OFFSETS, INSTEAD OF THE PRIVATE SECTOR APPROACH WHICH NOW DOMINATES, WOULD DO MORE TO SOLVE THE PROBLEM. THE HISTORY OF UNITED STATES GOVERNMENT INTERVENTION IN AREAS SUCH AS THIS IS NOT ONE WHICH WOULD INSPIRE CONFIDENCE IN THIS ALTERNATIVE.

EVERYONE RECOGNIZES THAT OFFSETS CAN HAVE BOTH POSITIVE AND NEGATIVE EFFECTS. IN THE DEFENSE ARENA, THE MAJOR NEGATIVE EFFECT MAY BE THE LOSS OF SUBCONTRACTOR WORK THROUGH THE GRANTING OF OFFSETS FOR OVERSEAS PRODUCTION. HOWEVER, THIS POTENTIAL LOSS MUST BE WEIGHED AGAINST THE BENEFITS OF BEING ABLE TO SELL THE WEAPON IN THE FIRST PLACE (WHICH USUALLY WOULD NOT HAVE BEEN POSSIBLE WITHOUT OFFSETS) AND AGAINST THE ALLIANCE AND FOREIGN POLICY OBJECTIVES WHICH OFFSETS FULFILL.

FOOTNOTES

1. International Coproduction/Industrial Participation Agreements, A report of the Department of Defense Task Group, Office of the Secretary of Defense, August 15, 1983, pp 3.

2. Ibid, pp 4.

3. Ibid, pp 4-5.

4. Ibid, pp 5.

5. Ibid, pp 6.

6. Ibid, pp 6-7.

7. Ibid, pp 7.

8. Memorandum on: General Policy on Compensatory Coproduction and Offset Agreements with Other Nations, Department of Defense, May 4, 1978, pp 1.

9. Ibid, pp 1.

10. Ibid, pp 2.

11. FMS Credit Guidelines, Defense Security Assistance Agency, Department of Defense, September, 1984, pp 1.

12. Ibid, pp 1.

13. Ibid, pp 1.

14. Security Assistance Management Manual, Defense Security Assistance Agency, Department of Defense, December, 1984, pp 9-3.

15. International Coproduction/Industrial Participation Agreements, op. cit., pp 9.

Chairman LaFalce. Thank you, Mr. Blaker.

Our next witness will be Mr. Joel Johnson, vice president for economic affairs, the American League for Exports and Security Assistance.

STATEMENT OF JOEL L. JOHNSON, VICE PRESIDENT, ECONOMIC AFFAIRS, AMERICAN LEAGUE FOR EXPORTS AND SECURITY ASSISTANCE, INC., ACCOMPANIED BY DAVID SCOTT, DIRECTOR, INTERNATIONAL TRADE DEVELOPMENT AND MATERIEL ADMINISTRATION, LOCKHEED CALIFORNIA CO., LOCKHEED CORP., AND JOHN KIRTLAND, ECONOMIC OFFSET MANAGER, INTERNATIONAL PROGAMS, DEFENSE EQUIPMENT GROUP, FMC CORP.

Mr. Johnson. Thank you, Mr. Chairman. I too am pleased to have the opportunity to participate in this hearing on behalf of the members of the American League for Exports and Security Assistance.

Our members include 29 corporations and 5 unions who basically wish to encourage Government policies that stimulate U.S. exports within the context of prudent security considerations.

I thought, Mr. Chairman, that this morning it might be helpful to have with us for your factfinding activities two gentlemen that not only worry about offsets but actually do offsets. I am therefore fortunate to have with me this morning Mr. Jack Kirtland on my far right, the economic offset manager, international programs of FMC's Defense Equipment Group, and Mr. Dave Scott on my immediate right, director of international trade development materiel of the Lockheed California Co., a division of Lockheed Corp.

They both flew in from the west coast yesterday for these hearings. I plied them with coffee, and I am certain they will be very helpful in discussing how offsets are actually demanded, negotiated, and administered in today's competitive environment.

The general topic of the discussion this morning, as I understand it, is how offsets relate to U.S. competitiveness. It seems to me there are actually perhaps two subthemes that need to be addressed in this area.

First, do the demands of foreign customers and the strong competition provided by industries in other countries require U.S. firms to offer offsets as part of their sales efforts? If so, are such demands increasing, and what, if anything, should the U.S. Government do about it?

Second, do transactions with offsets, while helping to promote sales in the short run, lead to increased international competition for U.S. firms in the long term because of technology transfer that relates to those offsets? I will try to touch briefly on both of those themes and, again, I will condense that testimony considerably.

At the outset, though, I would like to note—as did Mr. Blaker—that the offset issue is complex in part because it involves a lot more than just economic issues. This is particularly, of course, true in the case of defense equipment.

I would plan on limiting my testimony this morning to the economic issues which I presume are the subject of these hearings, but I think we should be aware that U.S. security, influence, and foreign policy interests are also associated with offsets, and we cannot ignore them when it comes to actually making offset policy.

While we too await with anticipation the study that is due in October, I think there is certainly general agreement at this point that both developed and developing countries have increased their demands for offsets over the recent years.

There are a number of factors that motivate countries to do so, and I think we know a good bit about them already. Both in the case of developed and developing countries, purchasers of high technology equipment see offsets as ways of obtaining new technology and increasing employment in their countries.

This is particularly true for purchases of defense, energy, and transport equipment, which is not surprising. These are goods which most foreign countries cannot produce locally but must have—either for development or security purposes. They are products that have high unit prices and are major drains on foreign currency.

Such purchases are very politically visible. They are generally made by foreign governments or state enterprises with taxpayers' funds.

This touches on a point you brought up earlier, Mr. Chairman. In almost every case, offsets are transactions between private firms on our side of the table and governments or government enterprises on the other side of the table.

It is very difficult to do offsets between private and private institutions.

The governments, consequently, feel a need to demonstrate to their public that they have obtained the best possible deal in terms of price, jobs, sales of domestic product and technology transfer. Again, aside from the economics, clearly offsets become a political issue at the other end of the transaction as well as this one.

In addition to the above considerations, recent global economic conditions have also increased the pressure for countertrade provisions as part of an offset package, particularly with respect to developing countries. Problems such as foreign exchange shortages, overvalued exchange rates, diminished access to industrial country markets for their more traditional products, and serious indebtedness make countertrade particularly attractive to many Third World countries. In the case of some high-cost transactions, such arrangements are the only way such a country can make such a purchase.

Again, I realize that your subcommittee over the last few weeks has held hearings on almost every one of these conditions, and I probably could not add very much to what you are already quite familiar with.

In terms of the U.S. companies, while it is clear why foreign customers ask for offset and countertrade, the more interesting question, I suppose, this morning is why companies accept them.

I think it is safe to say that most of our companies would prefer not to. Corporations in the business of making aircraft, powerplants, or locomotives really are not enthusiastic about getting into marketing unrelated products or becoming technical advisers for foreign governments or concerns. That is really not the business they specialize in. They prefer to go about producing what they do know how to do best and getting paid cash for what they sell.

The simple truth, however, is that in today's competitive world environment—for some of the reasons I just mentioned—if one bidder on a contract is willing to make such concessions and the purchaser demands them, others are going to have to unless their product is so unique that they have no other competition. Realistically, today there are strong competitors for almost every U.S. product.

In the defense area, for example, last year's sales to the developing world by the French and the U.S.S.R. each exceeded those of the United States—in one case by $2 billion, in one case by $1 billion.

Many other countries are increasing their market shares, such as Israel, Brazil, Italy, and Spain. Increasingly tight export controls for security reasons make it even more difficult for a U.S. product, which can obtain approval for shipment by the U.S. Government, to be that technologically superior to that of any other product produced by competitive countries.

Thus, from the perspective of the U.S. companies, the question is not so much how to deal with or without offsets, but whether to have a deal at all. They have to determine whether to increase business with an offset connection or not get the business at all; whether to increase employment by obtaining new contracts with some offset provisions or maintaining or decreasing employment because they do not get the foreign business.

The need to participate in offsets, however, does not mean that companies do not have any control over what they offer in offsets. Clearly, a company makes an offer only if it is convinced on balance it will be better off if it got the business than if it did not, including the offset provision. Companies have to make profits to survive. Thus they only sign contracts which are to their net economic benefit.

Furthermore, companies are aware that technology transfer can create future competition. They are very unlikely, therefore, to transfer production technology that is state of the art. If they do, it is likely the company knows that in the back room it has something even better that it is about to incorporate into its production process. The time horizon of most companies extends beyond an immediate transaction, it too has to look to its future sales.

I should note in this context something that sometimes gets overlooked, that production technology is itself a highly perishable commodity. When it is new, it is very valuable. When it is obsolete, you cannot give it away. Therefore, the challenge for companies incorporating transfer production technology in an offset transaction just is not deciding whether to sell production technology in a direct sale, it is to determine the point at which that technology still has a value but is not a threat to itself in terms of foreign competition using that technology.

Finally, as your opening statement points out, obviously there is another actor with an interest in this activity, Mr. Chairman, that of the U.S. Government. You have touched on a number of questions in your opening statement that are certainly legitimate concerns of the Federal Government.

Are there trade-distorting elements? Are there long-term economic risks associated in terms of offsets for technology transfer? Is there a net adverse impact on certain kinds of subcontractors of the defense/industrial base? These are certainly legitimate public policy questions.

Again, however, I would note that one would have to evaluate them in more than simply economic terms but also in terms of other issues. Again, I will limit myself, however, here to the economic ones.

We again, as I mentioned, are looking forward ourselves to seeing the data that has been collected as a result of the activity of this subcommittee by the Interagency Task Force on Offsets. It is only fair to point out here that there is a clear concern of the business community with respect to that information.

We would only hope that the data would be handled, both within the executive branch and in the Congress, in such a way so as simply not to whet the appetite of foreign customers for even more in the way of offset concessions. As you well know, the last best deal for one customer is the opening negotiating position for the next customer.

While recognizing the need for aggregate data, we again urge both the executive branch and the Congress to be cautious in how that data is made available. We are willing to help increase the knowledge of our own Government to make intelligent policy and, as you know, certainly all of our companies and many others have contributed many man hours in producing the data required by the Government.

But we do not want our Government inadvertently providing a free education on offset practices to our customers or to the competition. One can be reasonably certain a similar study will not occur in France that would benefit us.

Our other area of preoccupation, of course, is that we would hate to see a unilateral effort to try to fix this problem insofar as there is a problem. In some respects, I suppose offset practices are analagous to the problems encountered with official export credits. We can unilaterally cut them off, but if others do not you wind up transfering jobs and contracts to other countries that maintain an export credit system.

Similarly, if we are going to compete head-on with other countries, we have to have the flexibility in the offset and countertrade area as long as those practices are conducted by other supplying countries.

I would note that the United States already has in place a complex system of reviewing technology transfer from a national security perspective. As became painfully clear to all of us working with this issue, the 2½ years it took to get a new Export Administration Act made it reasonably clear that there is a great deal of dissention within the Congress and within the executive branch—within the private sector for that matter—on how to apply such controls.

I think any effort to apply similar controls on economic implications of technology transfer would be considerably worse for all concerned. We do believe the private sector is capable of deciding what will come back to bite it and, therefore, deciding what it is willing to transfer as part of an offset agreement and what it is not.

Just very briefly, to make offset practices, particularly countertrade practices, less attractive, the best thing the Government can do is improve conditions, general conditions, under which trade occurs. If we can deal with the debt problem, if we can deal with exchange rates, if we can restrain ourselves on trade barriers on more traditional products, we may be able to slow down the interest in both countertrade and moving into technologies faster than countries ordinarily will do.

If a government feels the need to deal directly with offsets, it seems to us this must be done in a multilateral context which is difficult at best as we know, again, from our experience in export credits. But on the other hand it seems to us the only reasonable approach to take.

If there is a new round of trade negotiations, perhaps the subject should be on the agenda. Alternatively, as Mr. Olson has already mentioned, the OECD might provide a reasonable forum to move forward on this.

To summarize, then, we believe that U.S. corporations can best judge how to deal with the economic implications of offsets on a case-by-case basis. We cannot, however, deal with the climate within which we conduct those transactions, that is the general trade climate. Only Governments can do that. In terms of directly dealing with offsets, we strongly encourage that one look to the multilateral route rather than the unilateral route.

The worst thing, worst possibility, of all from our perspective would be unilateral efforts to fix a problem which would basically "save" U.S. business and jobs by eliminating them. Rather the Government, I think, must pursue any actions aimed at directly affecting these practices through multilateral channels.

Once again, Mr. Chairman, our thanks for this opportunity to talk with you this morning. My colleagues and I will obviously be pleased to respond to questions.

[The prepared statement of Mr. Johnson follows:]

MANAGING WORLD TRADE: THE OFFSET ISSUE

STATEMENT OF

JOEL L. JOHNSON

VICE PRESIDENT - ECONOMIC AFFAIRS

AMERICAN LEAGUE FOR EXPORTS AND SECURITY ASSISTANCE, INC.

Before the

COMMITTEE ON BANKING, FINANCE, AND URBAN AFFAIRS

SUBCOMMITTEE ON ECONOMIC STABILIZATION

HOUSE OF REPRESENTATIVES

July 24, 1985

Managing World Trade: The Offset Issue

Mr. Chairman:

I am pleased to have the opportunity to participate in this hearing on behalf of the members of the American League for Exports and Security Assistance. Our members, which include 29 corporate and five union members, wish to encourage government policies that stimulate U.S. exports within the context of prudent security considerations. I have attached a list of those members to my printed testimony.

I am fortunate to have with me this morning two officers from ALESA member companies who have long experience with offset practices. Mr. John Kirtland is Economic Offset Manager, International Programs, of the FMC Corporation's Defense Equipment Group. He has come in from San Jose, California for the hearing. Mr. Dave Scott is the Director, International Trade Development and Material, of the Lockheed California Company, a division of the Lockheed Corporation. He has also flown in from the West Coast for this hearing. With the help of these gentlemen, I am certain we can answer any specific question on how offsets are actually demanded, negotiated, and administered in today's commercial environment.

The general topic of discussion this morning is how offset practices relate to U.S. competitiveness. There would actually seem to be two major sub-topics with respect to this theme. First it is necessary to discuss whether the demands of foreign customers and the strong competition provided by industries in other countries require U.S. firms to offer offsets as part of their sales efforts. If so, are such demands increasing and what if anything can or should be done about it? Second, do transactions with offsets, while contributing to increased sales in the short run, lead to increased international competition for U.S. firms in the long term because of technology transfer related to those offsets? I will try to address both these themes.

At the outset, however, I should note that the offset issue is also extremely complex because it involves more than just economic questions. This is particularly true in the case of offsets related to exports of defense equipment. Although these hearings, and this testimony, is primarily focused on the economic aspects of offsets, we cannot lose sight of the fact that trade in general, and especially trade in defense equipment, involves more than economic transactions. U.S. security, influence, and foreign policy interests are also intimately associated with such trade.

For example, the U.S. has a number of specific security objectives, such as enabling friendly countries to defend themselves, increasing the commonality of our weapons systems and those of our closest allies, and finding economic means to increase conventional warfare capacity in Europe so as to reduce the likelihood of having to resort to nuclear weapons. These objectives are all related to trade in defense equipment, and often to associated offset arrangements. This is probably not the appropriate forum to pursue such subjects in depth. It is important, however, that in discussing economic issues we do not lose sight of the fact that these other factors are also critical in determining overall U.S. policy with respect to the issue of offsets.

I would also note that I will not propose carefully delineated definitions of offsets and their components. There are as many definitions as there are writers about the subject and practitioners of the activities. For purposes of this testimony, by offset, I mean a transaction in which the foreign purchaser requires that the seller perform some service for the purchaser in addition to providing the good or service which is the immediate subject of the transaction. Such services may include joint production, incorporation of goods made by the consuming country into the end product being purchased by that country, the promotion of sales in the U.S. or third country markets of goods and services produced by the purchasing country, and the acceptance of other goods and services produced by the consumer as partial payment for the product. When I use the term countertrade, I will be referring to a component of an offset agreement which requires that the seller ~~also~~ accept or dispose of a certain amount of goods produced by the purchasing country.

Regardless of specific definitions, there is general agreement that in recent years the demand by foreign customers for offset arrangements has increased. We certainly see evidence of this phenomenon at the company level, where corporations have increasingly established offices to help negotiate, coordinate, and conduct offset and countertrade operations. However, we do not know all that much about how important offsets have become relative to overall U.S. and world trade. Current estimates vary greatly. We will presumably know a great deal more about the magnitude of these practices when the data that has been collected from the U.S. corporate community for the Defense Production Act has been processed.

Customer Interests

The factors motivating countries to increasingly require offset arrangements are also reasonably clear. Both developed and developing country purchasers of high technology equipment see offsets as a way of obtaining new technology and of increasing employment in their countries. In some instances this may be in the U.S. interest if such an agreement helps a friendly country improve its ability to provide for its own defense or to strengthen its economic base. On the other hand, such arrangements may well lead to countries investing in technologies which they cannot handle, or for which they will find it difficult to find markets after the original transaction expires. Similarly, labor may be attracted to a sector which is only viable in the context of a particular deal. Nonetheless, the immediate jobs and technology transfer aspects of a transaction may make the deal politically acceptable in the consumer country.

The offset study data will also tell us a good bit more about which sectors are most seriously affected by countertrade and offset practices. It is likely such data will tell us that demands for offset and countertrade by foreign customers are concentrated on purchases of defense, energy, and transport equipment. This is not surprising. These are goods which many foreign countries cannot produce locally, but must have, regardless of their economic circumstances, if they are to provide for their defense and improve their economic growth prospects. Such products generally have high unit prices, and hence are a major drain on foreign exchange and credit lines. They incorporate high technology, and therefore represent areas in which other countries would like increased investments and knowledge. And they are politically visible purchases, generally made by foreign governments or state enterprises with taxpayers' funds. Governments consequently feel a need to demonstrate to their public that they have obtained the best possible deal in terms of price, jobs, sales of domestic product, and technology transfer.

In addition to the above considerations, recent global economic conditions have also increased the pressure for countertrade provisions as part of an offset package. Especially for many developing countries, a combination of foreign exchange shortages, over-valued exchange rates, diminished access to industrial country markets, and serious indebtedness makes a countertrade component of an offset agreement attractive. Particularly for high cost transactions, in fact, such arrangements may be the only way a country can realize a purchase:

--Purchasing foreign goods generally requires use of a hard currency. For countries facing severe shortages of such currencies, countertrade may be used as a way to generate such currency to offset the original outlay.

--Ordinarily foreign exchange is obtained through exporting ones own products. Industrial countries have recently increased trade restrictions against commodities and goods which developing countries can produce on a commercially competitive basis. This encourages them to demand countertrade arrangements, in which the marketing structures of large foreign companies can be used to help find new markets. Offset agreements can include technology transfer provisions to assist countries in producing new items, often in high technology areas, which are less protected in industrial country markets.

--The foreign exchange problem often is further complicated by over-valued exchange rates in the Third World, which makes the prices of a developing country's goods unattractive on open markets. Countertrade offers a way to discount the prices of those goods while avoiding the politically sensitive step of devaluation.

--Finally, in a number of cases, countries are under IMF programs which restrict their ability to acquire new debt, or the countries are simply such poor credit risks that they cannot obtain credit through commercial channels. A countertrade transaction helps overcome these limitations.

Incidentally, it should be noted here that in the case of developing countries in which the U.S. Government has an interest in promoting the capacity for self defense and/or economic development, one way around the lack of resources is for the U.S. to provide increased foreign assistance. At a time of severe budget limitations, however, this is increasingly difficult. Thus, in some instances offset arrangements may well have to be regarded as an alternative to direct U.S. Government concessional assistance.

U.S. Company Perspectives

While the reasons foreign customers increasingly require offset and countertrade arrangements are clear, the more interesting question is why companies accept offset requirements. Most would certainly prefer not to do so. Corporations in the business of producing aircraft, or power plants, or locomotives, are not enthusiastic about getting into activities such as marketing unrelated products or becoming technical advisors to foreign companies or governments. Most companies would prefer to go about producing what they know how to do best, and to get paid cash for what they sell.

The simple truth, however, is that in a competitive world environment, if one bidder on a contract is willing to make such concessions, others will have to, unless their product is so unique that they have no other competition. Realistically, today there are strong competitors for most U.S. products. In the defense area, for example, last year sales to the developing world by both the French and the USSR each exceeded those of the U.S. Many other countries are increasing their market shares such as Israel, Brazil, Italy, and Spain. Increasingly tight export controls for security reasons make it even more difficult for a U.S. product, which can obtain approval for export by the U.S. Government, technically to be substantially superior to those of our competitors.

Incidentally, the extraordinary strength of the dollar further contributes to the pressure on U.S. producers to participate in offset and countertrade arrangements. Facing stiff foreign competition in product quality, severe U.S. Government limitations on technology transfer, and a highly disadvantageous pricing situation because of the over-valued dollar, imaginative offset and countertrade offers become an important part of the overall package in trying to present an offer which can beat the competition. In a rather perverse way, the magnitude of U.S. offset commitments in recent years, and the continued strong contribution to our balance of trade made by the defense, transport, and energy sectors, is reflective of U.S. industry's success in coming up with such packages in spite of other disadvantages which are outside of our companies' control.

Thus from the perspective of the U.S. companies, the question is not whether to accept a deal with or without countertrade or offsets. The question U.S. companies face in the current competitive international environment is between business with offsets or no business at all; increasing employment by obtaining new contracts with some offset provisions, or maintaining or decreasing employment because of no new foreign business. I would anticipate that the data obtained for the interagency study will indicate that U.S. business is doing fairly well in that environment.

The need to participate in the world of offsets, however, should by no means imply that companies have no control over what they offer. Clearly a company only makes offers which it is convinced on balance will leave it better off than if it did not have the business. Companies must make profits to survive. Thus they will only sign contracts which are to their net economic benefit.

Furthermore, companies are very aware that technology transfer can create future competition. They are most unlikely, therefore, to transfer production technology that is the state of the art. If they do, it is likely that the company knows it has something even better in the development stage for near-term incorporation into the production process. The time horizon of most companies extends beyond the immediate transaction, and consideration is given to future competition.

It should be noted in this context that production technology is itself a highly perishable commodity. When it is new, it can command a very high price. When it is obsolete, it cannot be given away. The challenge for companies incorporating technology transfer in an offset transaction, as in a direct sale, is to determine the point at which the technology still has a value, but is not a threat to the ability of the firm to compete in the international market over the longer term.

U.S. Government Policy Interests

The fact that this Subcommittee is holding these hearings implies that there is another party with an interest in offsets in addition to the seller and purchaser -- that of the U.S. Government. Certainly these practices raise some questions of legitimate interest to the government. Are there serious trade distorting elements involved in offsets? Are there long term economic risks associated with offsets which contain technology transfer provisions? These are some of the natural questions which come to mind. I would again note, however, that while these questions are important, they by no means include the full range of government interests in these practices, particularly in so far as trade in defense equipment is concerned.

As already noted, the study currently being undertaken by several Executive branch agencies should provide some answers to such economic questions, particularly with respect to the magnitude of offset practices. One concern of the business community should be noted in this context, however. We would hope that data would be handled in such a way so as not simply to whet the appetite of foreign customers for even more in the way of offset concessions. When the "best deal" from one customer's point of view is made public, you have created the opening negotiating position for the next customer. While recognizing the need for aggregate data on this issue, we urge both the Executive branch and the Congress to be cautious in making specific data available so that the problem is not made worse. We have no problem with increasing the knowledge of our own government to help it make intelligent policy. But we do not want our government providing a free education on offset practices to our customers or competition.

Our other area of preoccupation insofar as government actions are concerned is that we avoid trying to "fix" a problem through unilateral measures. In some respects, offset practices are analagous to the problems encountered in dealing with official export credits. The U.S. can unilaterally restrict or end its official credit programs, but if competitor nations do not follow suit, the end result will be to shift contracts, jobs, and profits to other producers. Similarly, if American companies are restricted in their ability to compete head to head in the area of offsets and countertrade, as long as these practices are seen as desirable by foreign customers, contracts will go to those countries and companies which can include such components in their offers.

It should be noted that the U.S. already has in place a complex system of reviewing any technology transfer from a national security perspective. As became clear during the long process involved in renewing the Export Administration Act, there is great controversy among agencies and within the Congress as to how best to assure that transfer of technology does not constitute a threat to U.S.

security. Were the government also to try to judge in specific cases whether technology transfer would or would not constitute a future threat to U.S. competitiveness, the likely bureaucratic wranglings would be far worse. Our members are convinced that they are quite capable of judging what the economic implications of technology transfer are from an economic standpoint, and that this is not an area in which increased governmental involvement would be helpful.

If the U.S. Government wishes to make offset practices less attractive it can best do so by improving the general climate within which trade takes place. If countries can gain access to industrial country markets, including our own, through the elimination of unreasonably restrictive trade barriers, their interest in countertrade will diminish, and the need to move prematurely into high technology products will also decrease. If a system can be devised in which exchange rates are less volatile and more accurately reflect true underlying shifts in market factors and comparative advantage, then countries will also feel less need to move towards a barter economy. Finally, if the debt problem of many developing countries can be handled in a way which allows for increased access to short and medium term credits, the need for less conventional means of doing business will be lessened.

If the government feels the need to deal directly with offsets, it can only do so constructively in the multilateral context. For example, if there is a new general round of trade negotiations, this subject might well be on the agenda, particularly insofar as it affects other trade issues, such as relate to government procurement or to subsidies. Alternatively, major supplier countries might discuss the subject within the OECD context, as has been the case with the question of export credits.

In sum, then, we believe that U.S. corporations can best judge how to deal with the economic implications of offset practices on a case by case basis. They cannot, however, deal with the general climate within which trade is conducted, and which may make offsets more attractive to foreign customers. Only governments can do that. In terms of directly dealing with offsets, there is little the U.S. Government could do on a unilateral basis which would not compound the difficulties involved in these practices, either by increasing the knowledge with which foreign customers negotiate these deals, or by limiting the negotiating abilities of U.S. firms and thereby shifting sales overseas. We do not want to "save" U.S. business and jobs by eliminating them. Rather the government must pursue any actions aimed at directly affecting these practices through multilateral channels.

Once again, Mr. Chairman, I would like to express the appreciation of our members for the opportunity to discuss this issue with you. My colleagues and I would naturally be pleased to address any questions you and other members of the Subcommittee might have.

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- Marine Engineers Beneficial Association, AFL-CIO
- United Brotherhood of Carpenters and Joiners of America, AFL-CIO

Chairman LaFalce. Thank you very much, Mr. Johnson. We will begin the questioning process.

Generally, I agree that it would be much preferable to proceed in a multilateral fashion, as opposed to taking unilateral steps. I do not know, though, that we necessarily need to rule out all unilateral steps. That is a decision that I think we can only make after we know the facts.

Mr. Olson, you mentioned that Korea had implemented an unbelievable offset program. Then you said that many NATO countries, as well as Japan and Australia, had incorporated increasingly significant offset requirements as a condition of sale on weapons systems; and on the next page, you said offsets could be important in dealing with the economic and debt servicing problems of nations, and that is particularly true with the less developed nations.

I think we certainly have to distinguish between the less developed nations and Japan, Australia, and the NATO countries. In the formulation of our decisions, are we groping with ways to distinguish between countries on the basis of whether or not they are developing nations or industrialized nations? Or have we not even reached the point where we are attempting to formulate policy?

Mr. Olson. Thank you, Mr. Chairman, I will try to respond to the question.

I think there may be some distinctions between the newly industrialized countries and NATO countries as opposed to less developed countries.

Our information right now is limited. We are anticipating getting data from the International Trade Commission, and I think that will assist us.

Over the last several months we have conducted a survey of our Foreign Commercial Service Posts overseas and we have made some observations from that data. But to answer your question in particular, whether there are distinct differences in offset agreements that are reached with the various groups of countries, at this time I am not really prepared to give you any observations on that.

Chairman LaFalce. Let me go behind that question a bit. First of all, let me understand how the administration is approaching that issue. When an offset problem arises, who is most responsible for the offset issue within the Reagan administration?

I now have before me the Commerce Department and the Department of Defense. But is there one person who is attempting to coordinate all activities regarding the offset problems?

Mr. Olson. Well, as far as regarding specific transactions, it is my understanding that the Defense Department in cooperation with State, for instance, establish a memorandum of understanding with the country in question which would permit the U.S. private company to negotiate a sales agreement with offset provisions.

Chairman LaFalce. An exclusively commercial transaction?

Mr. Olson. Exclusively commercial transactions. By and large, we have a policy of nonintervention. That is one of the problems in terms of assessing the magnitude of those commercial transactions.

Chairman LaFalce. Well, let us get away from the specific transaction—let us go to the report that this subcommittee mandated. I do not know who wants to address that.

How is that being handled, and by whom?

Mr. OLSON. Well, I can start on that. I will be glad to, Mr. Chairman.

Under section 309 of the Defense Production Act, it was an executive order that designated OMB to coordinate the preparation of that report.

Chairman LAFALCE. Who is the chief person at OMB right now directly responsible for that?

Mr. OLSON. Well, John Eisenhour.

Mr. GROTBERG. That is a sacred name. [Laughter.]

Mr. OLSON. It is spelled a little differently. [Laughter.]

To continue, Mr. Chairman, there have been a number of agencies supporting that OMB effort, including Commerce, Defense, State, Treasury. I may have missed one or two here.

But our responsibility within the Department of Commerce is to prepare the chapter on the impact of offsets on the U.S. industrial base. We are proceeding to do that. We have provided OMB recently a draft copy of our chapter.

Chairman LAFALCE. Is FEMA involved in it at all? Are they not the lead agency with responsibility for the industrial base?

Colonel WEIDA. They are involved tangentially. They have sat in on the meetings. They do not have the responsibility for a major challenge.

Chairman LAFALCE. Please continue.

Mr. OLSON. We are certainly going to make the delivery date of September 30 of this year. One of the key ingredients of that study was a questionnaire that was developed for the International Trade Commission by the agencies supporting the OMB chaired effort.

As I understood it, the International Trade Commission had a study underway on commercial countertrade. OMB was determined not to have a duplicate reporting requirement on U.S. industry and subsequently merged both activities. We provided information to OMB and ITC in preparation of the questionnaire.

The questionnaires were returned—I believe—March 29 of this year. ITC has aggregated the data and, I understand, has recently provided that data to OMB. So, we in Commerce are anxiously awaiting that data which will greatly assist us in refining our chapter.

Chairman LAFALCE. They sent it directly to OMB rather than Commerce, and you do not even have it yet?

Mr. OLSON. That is true. They are the overall coordinators of the report.

Chairman LAFALCE. That is the data that you need to prepare your section of the report, and it is not going to you. It is going directly to OMB, you are telling me. And OMB is working on it.

Mr. OLSON. Yes, Mr. Chairman. Well, ITC collected that data on behalf of OMB as the overall coordinator. So, I believe we will be getting that data very, very shortly. But we have done a significant amount of activities during the past year.

We have conducted an extensive search of the literature. We have also initiated our own survey, as I indicated earlier, of our Department of Commerce Foreign Commercial Service Posts overseas. We did a survey of 26 of those and we have come up with some observations.

Chairman **LaFalce**. I understand that ITC desires passing on aggregate data, and your department has indicated that you need better than aggregate data, you need the raw data; is that correct?

Mr. **Olson**. Well, we have provided a format of the data that we would like to see from OMB. We anticipate getting the data that we need from OMB to meet our needs.

Chairman **LaFalce**. Well, you are all part of the same government. It certainly seems to me that the sharing of information amongst our governmental agencies ought to be the simplest of all problems that we have to solve. [Laughter.]

We will see if we cannot help you, the executive branch, solve that one.

I still do not know that I have heard the end of what is happening here. From what you told me, it sounds as if the data is going in to OMB. What is happening from the Treasury perspective, if anybody knows that? What is happening from the State Department perspective, if anybody knows that? And clearly, what is happening from the DOD perspective?

Mr. **Blaker**. If I may, I would like to have Colonel Weida talk on that, he is the active person involved in this thing.

Colonel **Weida**. As Commerce did, we all submitted our requirements for data to OMB. I think there was a general realization that some aspects of the data would be too sensitive to be released. That was clearly one of the problems, I think, ITC had with the data.

OMB has been charged with maintaining the data file because this, I think, is a multiyear project.

Chairman **LaFalce**. What should be released to the public is one thing. What should be released to other agencies of the Government is something else.

Colonel **Weida**. That is true. But I believe that OMB is working as fast as they can to get this squared away in the data file, and then they will release it to us.

Chairman **LaFalce**. Well, that did not answer my questions about DOD, and State, and Treasury.

Colonel **Weida**. About their response to it? I think all of our response has been the same, and that is that we have an executive order which has assigned responsibility on this to OMB. It is their responsibility to take the data and to issue it to us.

Chairman **LaFalce**. Now, a number of you have stated that the U.S. companies are often-times reluctant to engage in offsets and so they will exercise their best judgment. They will not give any more transfer of technology than is necessary, et cetera, et cetera.

The fact of the matter is, invariably they are going to do most anything they have to do to get that sale; are they not? So, they are involved in a bidding war with other companies from within the United States and they are involved in a bidding war with companies from across the world. Chances are, almost any offset arrangement is still going to leave the company better off than it was without the contract. They are in a position where they are just going to have to give away as much as possible to get the contract; is that not true?

Mr. **Johnson**. Well, Mr. Chairman, no more than giving away at any price to get a contract.

Chairman LaFalce. They are going to wind up with somewhat of a net profit, to be sure. But, you know, some small net profit is better than no contract. The point is, you give away the store up until that point.

Mr. Johnson. Companies do walk away from deals, including on the basis of offset. Perhaps you gentlemen beside me have experience on that. But I know certainly around the table I have had discussions with various of our member companies on specific deals. There are countries they will not do business with, under any circumstances, simply because it is not in their long-term best interest to do that.

Mr. Scott. Within our corporation we have set up some pretty definitive guidelines on how we will handle the discussion of offset when it comes up in a proposal or a marketing effort, what kinds of things we will get involved in and will not get involved in. Of course, they change over time.

We divorced our offset organizations—which is my organization, countertrade—from our marketing organizations specifically for the purpose of having a check and balance so that we will not promise them anything that we may not be capable of accomplishing.

Chairman LaFalce. Do they talk with each other?

Mr. Scott. They talk to each other, but our marketeers cannot discuss offset with a potential customer. They cannot make an offset commitment. They cannot enter into agreements. They can advise me, for example, on what they think the requirement is.

Chairman LaFalce. They do not say, "Look, I am not going to get it unless we give them what they ask for"?

Mr. Scott. They do that. They do that very often. By the same token, by our own reporting levels we have a mandate from the chief executive of the corporation that says that we will not commit to do something that we are not capable of doing. In other words, if the offset requirement is something we cannot do, we will not do it.

Chairman LaFalce. Well, I think we should not have square circles and, therefore, I think, you should not commit to do what you cannot do.

Let me go on to Mr. Olson. You say that you are currently seeking a multilateral consensus on countertrade. Tell me about that because I think that is extremely important. How are we attempting to seek this multilateral consensus on countertrade issues? That is what our legislation mandated that you do—to seek a multilateral consensus on countertrade issues. What progress has been made on that and who is taking the lead on that? I mean, that is not OMB, is it? Is that Commerce?

Mr. Olson. That is USTR.

Chairman LaFalce. Pardon?

Mr. Olson. That is USTR, they have been working with it, Mr. Chairman, the OECD, and the report that I referred to in my testimony was done in 1984. It was not a published report.

Chairman LaFalce. It was or was not published?

Mr. Olson. It was not a published report.

Chairman LaFalce. Our subcommittee does not have a copy of that USTR report. Could you provide us with a copy of that report?

Mr. **Olson**. I will be glad to try to provide one.

Chairman **LaFalce**. Please provide it.

Mr. **Olson**. All right.

[The report entitled "Countertrade: Developing Country Practices" may be found on p. 651.]

Chairman **LaFalce**. Is there anything else you want to say about developing this multilateral consensus?

Mr. **Johnson**. Just a point on that, Mr. Chairman, that is anecdotal but of interest. About 9 months ago, I had a gentleman from the Canadian Defense Department in my office discussing offsets. He was doing the policy study.

What was interesting is, he had no part of his mandate to worry about what he can do in offsets as opposed to demand. I noted that the day before I had read that Canada was giving a 300-percent offset to Belgium in order to sell Canadian subway cars. Whatever policy he formulated for Canada might also come back to bite him.

I think you may increasingly see some of that amongst some of our industrial supplier countries, countries such as Canada, who find themselves paying as well as demanding offsets.

There is a problem, certainly, in terms of an asymmetry in that in most of what we think of private commercial areas—transport, power, et cetera—we do not demand offsets, cannot demand offsets in that area where in most countries transport, telecommunication, et cetera, are government.

On a civilian side it may be more difficult in some respects to find certain areas of agreement then on the military side.

Chairman **LaFalce**. Do we know that the report that we are going to receive is going to make this distinction that Mr. Johnson is referring to? That is the fact that in the United States something might be private, but in other countries it might be public and, therefore, there could be a deficit in the policy.

Colonel **Weida**. I think it will. We, in the process of looking at the multilateral negotiations were impressed, I think, with one fact more than anything else, and that was that the foreign governments we talked to were probably less capable of handling offsets than our Government.

Chairman **LaFalce**. Who is the lead person in USTR in this issue?

Colonel **Weida**. Steve Falcon is.

Chairman **LaFalce**. Mr. Olson, on page 7, you make reference to a study prepared by the GATT Secretariat on countertrade. Is that a public study?

Mr. **Olson**. No, Mr. Chairman, that is also an internal document.

Chairman **LaFalce**. Would you please submit a copy of that study to this subcommittee?

[In response to the request of Chairman LaFalce, the following memorandum was received from Mr. Olson:]

OFFICE OF THE UNITED STATES
TRADE REPRESENTATIVE
EXECUTIVE OFFICE OF THE PRESIDENT
WASHINGTON
20506

August 14, 1985

MEMORANDUM

TO: Walter J. Olson
Deputy Assistant Secretary for Export Administration
Department of Commerce

FROM: Carmen Suro-Bredie
Director for the European Communities
Office of the U.S. Trade Representative

SUBJECT: Hearing before the Economic Stabilization Subcommittee
July 24,1984

I was asked by your office to provide a status report on the work being done by international organizations on offset, countertrade, and barter problems, specifically which documents might be made available to the Committee.

ORGANIZATION FOR ECONOMIC COOPERATION AND DEVELOPMENT (OECD)

OECD Member states took a position on East-West Countertrade as early as 1981. The text of their position is contained in an OECD publication entitled EAST-WEST TRADE-RECENT DEVELOPMENTS IN COUNTERTRADE OECD PARIS 1981.

OECD Members have also discussed North-South Countertrade without coming to any final conclusion. The policy paper prepared by the OECD Secretariat has been declassified and will be available shortly.

GENERAL AGREEMENT ON TARIFFS AND TRADE (GATT)

Discussion on offset, countertrade, and barter began in the GATT in July 1984 at the request of the United States. A paper was produced by the GATT Secretariat which remains classified by the GATT while the Contracting Parties review this problem. At your request, we can brief the Committee members on this document but we are not allowed to release it.

Chairman LAFALCE. Mr. Blaker, in your testimony you point out the potential value of offsets, beginning on pages 1 through 3: "A. Deter aggression by enhancing the preparedness of allies and friends."

And then you say, well, it does not do this very significantly.

You say: "Increase the ability of the U.S. to project power," but then you say "offsets have no direct bearing on that objective."

You say: "Support interoperability with the forces of friends and allies." And you say, "but offsets are really negligible as far as that is concerned," and et cetera, et cetera.

With most all the arguments on behalf of offsets that you advanced, you then said it is either relatively insignificant or negligible, or has no direct bearing. I just wanted to point that out.

Mr. BLAKER. Thank you, Mr. Chairman. [Laughter.]

Chairman LAFALCE. I have a lot more questions, but I think we ought to go to the other members of the subcommittee. Mr. McCandless, do you have any questions?

Mr. MCCANDLESS. I have listened to your testimony with a great deal of interest, and I keep coming back to the term "free enterprise," and negotiation of a contractual agreement mutually advantageous to those involved.

I have difficulty in view of Mr. Olson's comment that we do not want to play all of our cards and make experts out of the system. And yet, we have a situation here where possibly we are talking about a policy.

Having come from the automobile industry and negotiated with customers for a period of 30 years, there really was a policy that we would like to have. We would like to get full sticker price on our cars but we knew that was not possible. So, one did what they could in light of competition and terms and conditions of the market.

How can we resolve the idea of developing a policy with all these three great ingredients involved? Mr. Johnson?

Is it possible to develop a policy?

Mr. JOHNSON. Well, first I think—coming back to an issue that the chairman was asking about—offsets in some respects are no different than what bells and whistles you get on the product and the total price you pay. I mean, you are not helpless on any one negotiating features—in an automobile whether you get the AM/FM radio thrown in or you do not; or you lower the price, or you get financing. There are many variables in a deal.

An offset is one of those variables. You raise one, you lower another and it is pretty hard to treat one in a vacuum except perhaps insofar as the demands governments make on you. When a government promulgates a policy, that is no longer a variable for the corporation. It is going to have to include something in its deal—to offset 20 percent. You may be very skillful in terms of how you count what you can do. These gentlemen beside me get paid for doing that.

But nonetheless, you are going to have to include something in your offer under certain circumstances.

Mr. MCCANDLESS. Well, I understand that.

Mr. JOHNSON. In any case, to get to the point I was making, offset is a component of a deal like all the other components of a deal. They all move interchangeably one with the other. So it is hard to single one out for control except, certainly no offset transfer technology you can agree to without a license from the Commerce Department or the State Department if it is on the commodities list.

So, that is the first control you already have. From a security aspect, these guys cannot make a deal on anything that the U.S. Government has not agreed to. In fact, in the munitions list it is an even stronger criteria in terms of sale.

Mr. McCandless. I understand all that. What are we talking about in terms of policy? Are we talking about a multipage book that says: "If you get involved in this, the policy shall be this. If you get involved in this, the policy shall be that?"

Can it be structured in that way?

Mr. Johnson. The first question is dealing in policy.

Mr. McCandless. As I understand it, in the chairman's opening remarks he talks about a national policy.

Mr. Johnson. A policy may be that the Government does not interfere, that is a policy.

Mr. McCandless. That is the extreme policy.

Mr. Johnson. Yes, but it is a policy. A policy is, we only interfere in national security issues, which is also part of the current policy. That is a policy.

A policy might have to do with, if it is a grant program you do or do not include offset. That will be a policy. It is an area government has control over. There are a variety of areas that government has direct control over.

A policy may be, you try to go in to the OECD and discourage or get agreement from other supplier countries not to make demands or not to make offers of certain kinds for certain products and certain sectors. That would be a policy.

Mr. McCandless. Could a policy include the Government as the turn-over agent for approval? Where two people are negotiating, the negotiations are heavy on one side and light on the other, yet the commodity involved is desirable.

"Let me see what I can do if the Government will agree to it." The Government says, "No, we do not agree to it." So, that helps the weak side of the policy negotiation to strengthen his position. Is that a potential policy?

Mr. Johnson. It is a policy. It is one I think we would be very concerned about, partly given the experience on the security side in which it does not do much good to have a heavy, if the heavy takes 2 years to make a decision, in which case the deal has already gone somewhere else. That is one of the problems of bringing one more agent into a negotiating process that does not have any particular vested interest in closing the deal.

Mr. McCandless. I would like to single out the commercial aspect from the military for purposes of our discussion and concentrate on the commercial aspect because the military, I think, takes another posture. Maybe I am wrong, but I think the two are not synonymous.

Mr. Scott. I might comment. I think what the subcommittee is doing to understand the subject of offset and countertrade and its implications is good. Everyone this morning has talked about offsets. But no one has really defined the problem or whether the problem exists. The report hopefully will provide some of that type of information.

Until you define that a problem exists, personally I think it is premature to talk about whether there ought to be a policy.

In most of the negotiations that I conduct with representatives of other governments in the area of offset that the actual people I negotiate with, I would not call heavies. They are very negotiable in spite of what their company or their country policy might say.

There is flexibility in negotiations which you are able to utilize.

Mr. McCANDLESS. Let us use a specific example that Mr. Olson used in South Korea. They implemented an offset program and you went into details of this program.

Now, when you are negotiating with a representative of South Korea, he pretty well has this formula right in front of him and says: "If you want to do business with me, you have got to meet my government's criteria."

Mr. SCOTT. I have never negotiated with a representative of South Korea, so I cannot comment on South Korea.

Mr. McCANDLESS. But, theoretically, would that be the way it would be?

Mr. SCOTT. I have negotiated with other countries where the national policy, or the requirement, was 30-percent offset of the value of the transaction must be in defense or high technology-related areas, and other statements of national policy where the negotiated offset agreement nationally signed has been not in complete conformity with those requirements.

Mr. McCANDLESS. Another country involved.

Mr. SCOTT. In another country with a representative of that country.

Mr. McCANDLESS. Your experience is that these numbers and policies dealing with factors of mathematical equations tend to have some shrinkage to them, depending upon how desirable it is.

Mr. SCOTT. Even the math is not always clearly understood. We have had a program where we were represented by another country that we had agreed to a 100-percent offset program. And when we discussed it, we described it as a 30-percent offset program.

Both were right because the other factor that becomes involved is time. In the case of where the country talked about a 100-percent offset program, they are taking today's value of our product and saying, "OK, the offset obligation is that number of dollars in today's dollars, therefore it is a 100-percent."

The difference was, we negotiated 15 years to complete the agreement. As time goes on, the dollar changes due to inflation, and you have to do less work in order to achieve the same level of dollars. But within that country they publicized it as 100 percent because it sounds good.

Mr. McCANDLESS. I feel like I have been on a merry-go-round here where I have gone around and back.

Chairman LAFALCE. Mr. Vento.

Mr. VENTO. Thank you, Mr. Chairman.

I have been listening, gentlemen, and gained some insights. Obviously, we are all looking forward to the report and hope that it is helpful. Obviously, we appreciate the comments to the subcommittee and your role in this.

I think, Mr. Chairman, you have done a good job in keeping the focus on it. Hopefully, we will have some hearings in October when that report is back in—although it is a busy time.

Chairman LAFALCE. We will have hearings.

Mr. VENTO. The point is, in both the statements of Mr. Olson and Mr. Blaker they point out—and I think Mr. Johnson would agree—that offsets actually increase the cost of the product being purchased by a foreign government.

Mr. JOHNSON. Yes.

Colonel WEIDA. I would like to address that question because I think that that is something that we need to explore a little bit more.

It is true, based on grounds of economic inefficiency that offsets are bound to increase the price of the product. However, it is also likely true that the failure to grant an offset, which would result in loss of the sale, would also increase the price of the product.

So the question you are really dealing with is which of the two increases the price most.

Mr. VENTO. Well, in other words, you are talking about the fact that we are building so many units, the product is here, and by selling the product abroad we could actually build more units and would normally reduce our costs.

Colonel WEIDA. That is correct.

Mr. VENTO. But the fact is that the offset actually increases the cost on the units that are being sold there and does not reduce the costs of the units being built here.

Colonel WEIDA. That is not correct because what happens is that the offset is generally for a small portion of the product, and we still proceed with the production of the major part of it.

Mr. VENTO. Well, that is true, I guess, you have to get down to the specific product. But for instance—I guess it goes down to whether R&D costs are incorporated or not.

Colonel WEIDA. That is right, and we have Government regulations on that as to whether or not they will be charged. As you are probably aware, we do not charge them to our more wealthy customers and do charge them to our less wealthy.

Mr. VENTO. That bothers me as a Democrat. [Laughter.]

What I am trying to find out, that generally speaking, is the increased cost of the product—it does not necessarily follow that to increase the number of units would directly result—unless we get into specific weapons systems or specific products—would necessarily result in a reduction in terms of costs for us. It may, and it may not.

In fact, you know, we may facilitate it by waiving, for instance, R&D costs or other factors.

Colonel WEIDA. Yes. I think that is an excellent point. As a matter of fact, it is one of the major ones we are facing on the interagency group that is working on this right now, and that is that it is difficult to tell.

Mr. VENTO. Yes; well, I think the whole sort of aura that exists here, Mr. Chairman, is an interesting one because we all say, "Well, the free market," and "Let the private sector decide all of those things." You hardly ask a question on this particular issue without getting into an item that has to have approval of the Commerce Department or the Department of Defense based on national security or based on government policy with respect to that particular product.

I mean the point is here, we are not necessarily only talking about selling automobiles or trucks. The fact is that the offset issues—I mean the real prime point here is we are dealing with generally sophisticated technology that has national security implications. It might be a computer. It might be an aircraft. It might be any host of products.

The whole concept of should the Government be involved is, I think, irrelevant. I think the question is, how is the Government going to be involved? I mean, how are we going to be involved? Are we going to be involved as we are today, or are we going to be involved less? Are we going to do something in a coordinated manner?

As an example it was pointed out memoranda of understanding are provided as a framework. The question is, which comes first, the negotiated deal between Lockheed and the Dutch Government on a sale of the F-16, I guess, or the memorandum of understanding which sets the parameters about what we are going to do?

Do you want to try that one, Mr. Blaker?

Mr. BLAKER. Well, let me make a general comment. What you are saying is absolutely true. It is very difficult to answer these things unless you deal with a specific case in point.

Second, the value of what you have asked us to do, to prepare the data base so that we can answer these questions, is something that has to be accomplished first.

I am not trying to hedge on this thing, but you are raising very important questions which from a parochial standpoint in the Department of Defense are as important to us as they are to you. We have to balance these things also. We have an interest in arms transfers which meet certain national security goals.

In some cases, if they facilitate getting base access, we are for them. But we are not for them if at the same time they erode the industrial base. So, we have to deal with these balances just as much as other people involved in this thing.

The value of what you are doing is that you are providing, or you are requiring that the fundamental data base that we can answer these questions from is being created. That is of great value.

But at the same time, you cannot expect us to define specifically what the policy should be until we get these facts, it seems to me.

Mr. VENTO. I agree. But I mean, my point is just to make a message here, in other words, the gentlemen from Lockheed said he went and negotiated with someone.

The point is, which comes first, the commercial negotiation, for instance, on a weapons system like an F-16 or take another product if that is bothersome, or the memorandum of understanding, or the granting of credit?

Obviously, Congress grants the credit, the President signs it.

Colonel WEIDA. Clearly the negotiation in whatever form, or at least the desire for the weapons system, comes before the memorandum of understanding. You should understand about those, though, that a memorandum of understanding is a political document.

First of all, there are not memorandums of understanding for all sales.

Mr. VENTO. I understand that.

Colonel WEIDA. OK. And the fact that you have a memorandum of understanding has nothing to do with offsets whatsoever. As a matter of fact, they are purposely not mentioned in there because, once again, we try and keep a hands-off attitude toward it.

So, the memorandum of understanding is merely a political document saying that we and, for instance, Thailand if they want to buy F-16's, are involved in an exchange, and that is good politics for them and it is good politics for us. But it really is not an offset issue at that point.

Mr. VENTO. Well, I mean the point is that very often DOD gets involved in a little different capacity. From time to time we have military personnel that go to Thailand or some place to demonstrate the capability of these various products that they would like to see enhance the defense of that country. Is that right, Mr. Blaker?

Mr. BLAKER. Yes, that is correct.

Mr. VENTO. In other words, these personnel are there and they are trying to, in essence, sell that particular product.

Mr. BLAKER. They are there because in the cases that they are sent out to do this, it is judged that the arms transfer which may result from this is of benefit from a national security standpoint.

We do not pay uniformed military personnel to go out and sell arms.

Mr. VENTO. But are they not there presenting competing products very often, one built by Lockheed, another built by Northrop or something?

Mr. BLAKER. Well, they demonstrate the options that are available, sure.

Mr. VENTO. They have another interest in that, too; do they not? Colonel Weida said earlier in terms of building more of that particular aircraft and reducing unit costs at home.

Colonel WEIDA. You are absolutely right. We have a Congressional Budget Office study which shows that that is a major factor in driving down the cost of weapons and, I guess, we tend to believe that. But, nevertheless, we expose the potential purchaser to the entire range of options.

Mr. VENTO. If we can discount what the effects are and do not quantify, maybe effects of the higher costs abroad or whatever, whether we waive research and development costs. A lot of other factors enter into it, letting them do it with FMS credits. We are doing a variety of things that would reduce the costs.

But in the end it may not be as cheap as we think.

Colonel WEIDA. That is true. But of course, remember if it is FMS credits, there are no offsets involved either.

Mr. VENTO. In general.

Colonel WEIDA. With one big exception which we will not discuss. [Laughter.]

Mr. VENTO. Well, we can discuss it if you want, just so we do not buy any of those aircraft. [Laughter.]

My time has expired.

Chairman **LaFalce**. Mr. Grotberg.

Mr. **Grotberg**. Thank you, Mr. Chairman.

I do not know whom to address this to, but somebody shared with me a Wall Street Journal article of March 13. In the last sentence Mr. Argentinas wants to generate exports for General Electric—not to make money from trading. If you believe that, the Sun will rise in the West tomorrow, right?

You are not in the airplane business, you are in the business to make money. That is the goal, that is the all-American goal. There is nothing wrong with it.

My concern then is that the Government stay out of countertrading for nonmilitary or nonhigh-tech territorial interests of the United States in technology.

Well—if in fact we are making no-cost deals overseas and we are in a single-source item in America—you know who is paying the marginal profit to any corporation. It is down to single source and, of course, there is not a lot of it left but there is a lot of it out there in big bucks. The American taxpayer is paying it and that corporation is making money.

Now, if the corporations are out there not to make money, then Mr. Argentinas is right and the corporate welfare and good citizenship thing has gone so far that I do not believe it.

My question then is: To what degree does our military on domestic purchases—single source items—pick up the slack for countertrading and/or the offset provisions?

Colonel **Weida**. Yes. The answer is, to no degree at all. As a matter of fact, we regard it a little bit more broadly than you do there, and that is that we do not allow a situation to develop which would require offset in any situation where even if it was not single source, if all the competitors were U.S. competitors—and that is to say that in situations involving foreign military sales that are managed by the Pentagon where the only possible competitors involved are military contractors in the United States, we simply do not allow offsets.

Mr. **Grotberg**. You can put the whammy on the deal if you see that end result?

Colonel **Weida**. In grant and loan deals those funds are going to be allocated and managed by the Defense Security Assistance Agency. They simply will not allow them to be spent in the type or manner which would be required in an offset deal. So, it is not allowed.

Mr. **Grotberg**. I still do not get it. I am a free trader.

Colonel **Weida**. OK. Well, there is no reason to allow it. Offsets are a negotiating tool to give you an advantage over someone else. It is not in the interest of the U.S. Government to have our own contractors negotiating off against themselves to gain some advantage—using our funds, then—to buy the money.

So, as far as we are concerned, if a country wants to come to us and use our money to buy weapons, that is fine and dandy. But do not look to us to also create a bargaining environment between our contractors.

Mr. **Grotberg**. I got you a little upset.

Mr. **Kirtland**. No, no, I just did not quite understand it. I do not know why a sole source is any different than anyone else because most of the time in our particular situation we are competing with companies from other countries. We would rather we did not have offsets. It is a nuisance and it is an extra expense.

We would rather, as Joel said here, close the deal for our product strictly on a cash basis. But it is another negotiating tool and, just like any negotiating tool, every offset deal we negotiate is different not only from country to country, but from deal to deal.

You sit down and talk about percentages, it gets the headlines. But as much or a bigger factor are the rest of the terms and conditions that go along with that offset agreement you are looking for, areas of mutual understanding and a give-and-take on both sides to satisfy both the customer country's political and economic concerns.

Mr. **Grotberg**. Well, maybe I judged harshly.

Mr. **Kirtland**. Well, let me just proceed, if I may. The point is that we only take an offset deal if we perceive it is necessary to get the business. So really, in net, the only choice if we do not do offset is to not get the business.

Now, I do not care how you cut it. I think that the whole U.S. economy is behind if we do not get the business because we would be giving up those jobs.

No. 2, everybody looks at the amount of offset and says, "That is how much essentially reverse flow of business we have out of the United States." Again, an incorrect perception.

A large percentage in the offset percentage that we make deals for already exists in things that are being bought overseas, and it is a matter of switching into the country where you have the offset arrangement.

Another item is that many of the exports that we buy from that country in the name of offset do not come into the United States and compete with U.S. industry. They go into other foreign countries. Other foreign companies that we had deals with help us in our offset. Many offset products go into Europe and into the Far East.

Finally, if you will just look at the basic economic situation you will find more and more of U.S. industry—because of the competitive situation and the strength of the dollar—are setting up, independent of any offset requirements, worldwide sourcing focuses to try to take advantage of the increased competitiveness overseas so that they can stay more competitive here in the United States.

You can look at offset as a way of getting foreign contracts, using it to get some business back into the United States in return for the already existing worldwide sourcing. So, I think we are looking at it in a wrong way. Sure, we would like to have the whole loaf, but half a loaf is better than not having any at all.

A couple more points.

Mr. **Grotberg**. All right.

Mr. **Kirtland**. The standpoint of costs. All of our purchases that we make in the name of offset are done on a competitive basis. That is why it takes us a long time to structure a deal.

The point is, just as Mr. Scott said, he and I are in positions of having to negotiate the deals and then personally having to make those deals work. So, we are only interested in coming up with something we can do. In our particular case, most of the stuff that we buy is purchased under the FAR's; that country has to be competitive just like the industry here.

So, it does not increase cost. It is not a case of subsidizing that industry overseas in order to buy those particular items. In addition, in terms of industrial base, in the military procurement we never put an entire procurement overseas of any given part. If we ever put any over, it is a matter of splitting the order.

In most cases all of our subcontractors, if they look at the amount of business they have due to foreign sales, have a net plus in terms of added business from foreign sales, as opposed to a minus.

Mr. GROTBERG. And in closing, Mr. Chairman——

[Laughter.]

Mr. GROTBERG. Thank you very much. All I am concerned with is that when you swap dollars, nobody makes money. But if the corporation is doing well, somebody is paying. It is a very simple theory and I think somebody is paying.

I am not quite finished with the topic, but if it is good corporate citizenship that is driving you to this, God bless you and welcome. [Laughter.]

I hope the Government does not screw it up. [Laughter.]

Thank you, Mr. Chairman.

Chairman LAFALCE. Ms. Kaptur.

Ms. KAPTUR. Thank you, Mr. Chairman. I want to commend you for your leadership in this area which I am learning more and more about. I believe you are providing some new information for the country which was probably needed 15 years ago.

But I have a couple of very simple questions of Mr. Scott. How long have you worked for your company?

Mr. SCOTT. Well, let me see——

[Laughter.]

Mr. SCOTT. About 16 or 17 years because it is split. I was there, gone, and came back.

Ms. KAPTUR. All right. But you have been in the defense business in some way most of your life.

Mr. SCOTT. That is correct.

Ms. KAPTUR. All right. How long have you held your present position? How long have you been in offset, director of international trade; how long have you done this?

Mr. SCOTT. Approximately 5 years.

Ms. KAPTUR. Five years. And was this a new type of activity for you in your company, or have you always been involved in sales?

Mr. SCOTT. I have never been involved directly in sales. I have been mostly in the materiel subcontracting area. I have had involvement in international business for probably—either through the subcontracting or the——

Ms. KAPTUR. Materiel, explain that please.

Mr. SCOTT. OK. Materiel is a term we use to describe our procurement, our purchasing functions, subcontracting functions; work that is done outside our own company.

Ms. KAPTUR. Work that goes on outside your own company.

Mr. SCOTT. Outside of our own company.

Ms. KAPTUR. Outside of your own company.

All right, Mr. Kirtland, would you answer the same questions? How long have you worked for FMC?

Mr. KIRTLAND. Thirty-two years. It all has been connected with military. I have been formally in the offset position for 6 years, informally for 10 years. Before being in that business, I was an engineer.

Ms. KAPTUR. And how long have you been in the offsets position that you now hold?

Mr. KIRTLAND. Six years.

Ms. KAPTUR. Six years. When did your company first create a position that dealt with offsets?

Mr. KIRTLAND. Six years ago.

Ms. KAPTUR. Six years ago.

Mr. SCOTT. Formally, in 1975. We have been doing it for about 20 years, and we formally structured it in 1975.

Ms. KAPTUR. Which countries do you do business with? Mr. Scott, which was the first one you ever did business with? What was your first big, hot deal?

Mr. SCOTT. Canada and the Netherlands were probably just about the same time, the first couple times, which I did.

Ms. KAPTUR. And which ones do you do business with now—three of the most frequent?

Mr. SCOTT. Canada, Australia, The Netherlands, Portugal, Belgium.

Ms. KAPTUR. And what about you, Mr. Kirtland?

Mr. KIRTLAND. The first one was The Netherlands and then Belgium, Spain, Greece, Israel, Canada, Australia.

Ms. KAPTUR. And neither of you have ever dealt with the Far East and Pacific areas?

Mr. SCOTT. Australia.

Mr. KIRTLAND. Australia is the only one for us.

Ms. KAPTUR. To your knowledge, which companies in the defense business tend to deal mostly with Japan and Korea?

Mr. KIRTLAND. I am not familiar myself of particular offsets policies in Japan.

Mr. SCOTT. There is not a formal offset policy in Japan.

Ms. KAPTUR. A lot of these are written into law?

Mr. SCOTT. I would say South Korea is probably—Northrop; about five sales might be involved. I think Hughes might be involved.

Ms. KAPTUR. I notice here in Mr. Blaker's testimony he talks about HAWKS in Japan back in 1967, F-4's in Japan in 1969.

Colonel WEIDA. Yes; those were old programs. That was Raytheon on some of those. But that has been shut down a long time ago.

Ms. KAPTUR. Gentlemen, if I may have your attention, I wanted to ask you, in the course of doing business now, what types of technologies are used in the process of selling? Break it down into real terms so I can understand it. What do you sell over there?

Mr. SCOTT. Under offset?

Ms. KAPTUR. Yes; I am curious. Are you selling fifth generation computers? Take some contract that you have negotiated with and give me an idea what type of product. Make it real for me. What type of thing are you selling over there?

Mr. SCOTT. I would define within our company that the type of technology transfer that we are talking about under offset programs is current state of the art, not advanced, and tied mostly into the kinds of technology where U.S. industry establishes the requirement. You send them a set of specifications.

Ms. KAPTUR. For example?

Mr. VENTO. Will the gentlewoman yield?

Ms. KAPTUR. All right, I will yield to the gentleman.

Mr. SCOTT. Printed circuit board material. Now, we have——

Mr. VENTO. If the gentlewoman would yield. But what are they trying to get? Are they trying to get the latest, yesterday's? I mean, Boeing has serialized its aircraft, commercial aircraft. They are doing carbon technology and that is the latest in metals stuff in Italy and Japan and other places that they are buying.

I expect that that might be true. They are trying to get the most advanced technology.

Mr. SCOTT. That is true in some countries. I say "some" because——

Mr. VENTO. But if I can continue, insofar as you are successful, you try to restrict that.

Mr. SCOTT. Right. There is an objective in some countries for very high technology and in others it is just technology that will bring their industry up to a worldwide competitive position. They are looking for the same thing.

For example, Australia, their big push is self-sufficiency. They are concerned about supply lines. They would like to have their industry be able, in case of an armed conflict or a supply line being cut, to produce as much as they possibly could in their country.

That is where, to a great extent, their offset program requirements are, to be self-sufficient.

Chairman LAFALCE. Are there any burning questions left?

Mr. VENTO. Mr. Chairman, I have other business.

Mr. GROTBERG. Thank you, Mr. Chairman.

Chairman LAFALCE. I want to thank all the members of the subcommittee for their attendance, and especially the members of the panel for their excellent statements.

The subcommittee will adjourn. I do point out, though, that we will be having a hearing on this contemporaneous, I hope, with the release of the report.

[Whereupon, at 11:55 a.m., the subcommittee adjourned, to reconvene subject to the call of the Chair.]

[A statement by the United Technologies Corp. (UTC) entitled "Impact of Offset on International Trade," and the report referred to earlier in the hearing, "Countertrade: Developing Country Practices" by the Organisation for Economic Co-operation and Development (OECD), follow:]

Impact of Offset on International Trade

SUBMITTED TO

United Technologies Corporation

Prepared for

U. S. House of Representatives
Subcommittee on Economic Stabilization
of the
Committee on Banking, Finance and Urban Affairs

Honorable John J. LaFalce, Chairman

As the nation's seventh largest defense contractor, and with forty percent of sales coming from overseas markets, United Technologies Corporation (UTC) has a vital interest in the issue of offset. UTC produces a broad-range of high technology products for defense purposes such as Pratt & Whitney jet engines, Sikorsky helicopters, Norden defense systems, and Hamilton Standard controls. In 1984, one-third of UTC's $16 billion in sales was to the U.S. Government.

An increasing number of developing countries are joining industrialized nations in imposing offset conditions as a requirement for doing business. This is particularly true in the foreign sales of military equipment where it is now commonplace to receive offset demands ranging anywhere from 15 percent to 100 percent - - and higher - - of the sales value of the product being sold. Offset has become a required and highly competitive element in many international sales.

Despite the fact that offset is becoming more commonplace, there is no commonly agreed to definition of "offset". It is a term whose definition has been debated almost as much as its implications. Some experts consider offset to be a subset of countertrade, while others believe just the reverse to be true. For the purposes of this statement, the term offset refers to a range of practices engaged in by purchasing countries which serve to "offset" the purchase price by a variety of arrangements. These arrangements generally require the seller to place a percentage of the sales value of the product being sold with the purchasing country in the form of economic and/or technological benefits.

At UTC, offset activities have doubled in the past two years alone. Since 1983, UTC's involvement in offsets has increased from 25 contracts/proposals in 10 countries to more than 60 contracts/proposals in 20 countries.

UTC's Pratt & Whitney (P&W) division's first significant offset experience was with the sale of the F100 engine on the F-16 fighter aircraft to the European Participating Governments (EPG) consisting of Belgium, Denmark, The Netherlands and Norway.

In this competition, the U. S.-built General Dynamics F-16 aircraft was pitted against the French Mirage. The purchasing countries made it clear that they would buy only an aircraft they could help build. The U. S. Government and the French were presented the choice of offering a work-sharing arrangement, i. e., coproduction, or no business at all. The United States won the competition, and the four countries placed orders worth more than $2 billion for 348 F-16s including 438 Pratt & Whitney engines. From an employment standpoint, this offset program generated thousands of man-years of work within the United States. From a defense standpoint it meant that the development costs of the F-16 could be shared across a larger production base. In addition, it promoted the interoperability of equipment in Europe and, more importantly, it strengthened NATO's defense posture in Europe.

The coproduction agreement was negotiated by the U. S. Government with the governments of the NATO countries. The resulting engine contract was worked out directly between Pratt & Whitney and the U. S. Government. It called for Pratt & Whitney to perform 90 percent of the production work on engines ordered by the U. S. Air Force, 60 percent of the engine production for the planes bought by the four NATO allies, and 85 percent of the production work on engines bought by other countries. A similar agreement was carried out with General Dynamics, the F-16 airframe manufacturer.

This left the EPG countries to coproduce 10 percent of the value of the initial U. S. aircraft and engines, 40 percent of the value of their own aircraft and engines, and 15 percent of the value of all so-called "third country" aircraft and engines.

Pratt & Whitney and General Dynamics had to develop and qualify suppliers that could do the required work in the four countries. This evolved into coproduction agreements in all four EPG countries and actual assembly lines in Belgium and Holland for the aircraft, and in Belgium for the engines.

Without this willingness on the part of Pratt & Whitney, General Dynamics and the U.S. Government to enter into a coproduction arrangement, the four European countries would have bought the French Mirage fighter instead of the F-16. The planes and the engines would have been built entirely in Europe by European workers. For everyone concerned on this side of the Atlantic - - government, industry, and labor - - it was either coproduction or no production.

In general, foreign governments today demand offsets not because of national security considerations, but for maintaining domestic employment, creating a national defense industrial base, acquiring modern technology, and assisting their balance of payments position. The scope of the agreements goes far beyond the product itself or the needs of the industry.

The majority of offset programs are military related, but some commercial programs are also contingent upon offset conditions. The General Agreement on Tariffs and Trade (GATT), through the Government Procurement Code, discourages signatory nations from requiring or demanding offsets associated with commercial programs, but only 20 countries, including the United States, have signed the Code. The GATT refers to the demands and/or requirements of the customer country. It places no discipline on an offer initiated by the seller. If a foreign competitor elects to offer offsets as an element of its proposal, the U. S. company is forced to do the same if it is to be competitive.

There is a common perception that offset programs tend to create new competitors through the transfer of technology. However, U. S. industry protects its investment in the latest technology by not allowing its transfer, and the U.S. State Department's Office of Munitions Control protects sensitive military technologies through extensive licensing review and approval procedures.

There are no easy answers to offset problems. Their complexity is evidenced by the many interests and opinions found within industry and the U. S. Government, and the general lack of consensus on either the scope of the problem or its solution.

For the most part, industry has been reluctant to participate in data collection surveys. Private company offset data is extremely sensitive, and useful to domestic and international competitors. U. S. companies need assurances that proprietary data and competitively sensitive data will be protected.

In 1983, when the Treasury Department was compiling a report on offsets in the aerospace industry, private company data were channeled through the Aerospace Industries Association, where it was aggregated. This procedure was useful and should be considered as a model for future handling of offset data. This method is not foolproof, however, since even when aggregated such information often is readily identifiable by our competitors both at home and abroad.

Accordingly, we are concerned about protecting confidentiality and respectfully urge that any future data gathering efforts reflect the need to protect proprietary business interests.

UTC and others in U. S. industry are also concerned that the collection and publication of offset information, even in aggregated form, could cause foreign customers to demand greater offset commitments in order to equal or improve upon what others have obtained before them. It would be most unfortunate if the very process of studying the offset issue were, in fact, only adding to our difficulties.

It's also important that we avoid imposing unilateral restrictions on industry's ability to enter into offset commitments. None of us likes offset, but we know that in many cases, it's a necessary component of overseas sales. U. S. industry's choice in offset competitions is "a percentage of something versus 100 percent of nothing." The U. S. aerospace industry's international competitive position faces serious challenges in nearly every area. We cannot afford international offset policy restrictions which do not apply equally to our foreign competitors.

Any action to control offset must be based on multilateral agreement among the selling nations. At the same time, negotiations to eliminate or set limits on an acceptable level of offsets should be undertaken with the participation and concurrence of the industries involved. Any such agreements should be structured carefully to ensure that they have no adverse effect on our ability to compete on an equal basis with our non-U. S. competitors and that they can be effectively implemented and enforced.

This can be done only by allowing industry's full participation in the government's deliberations on offset policy. We stand ready to offer appropriate assistance to the Subcommittee in regard to this matter.

Thank you.

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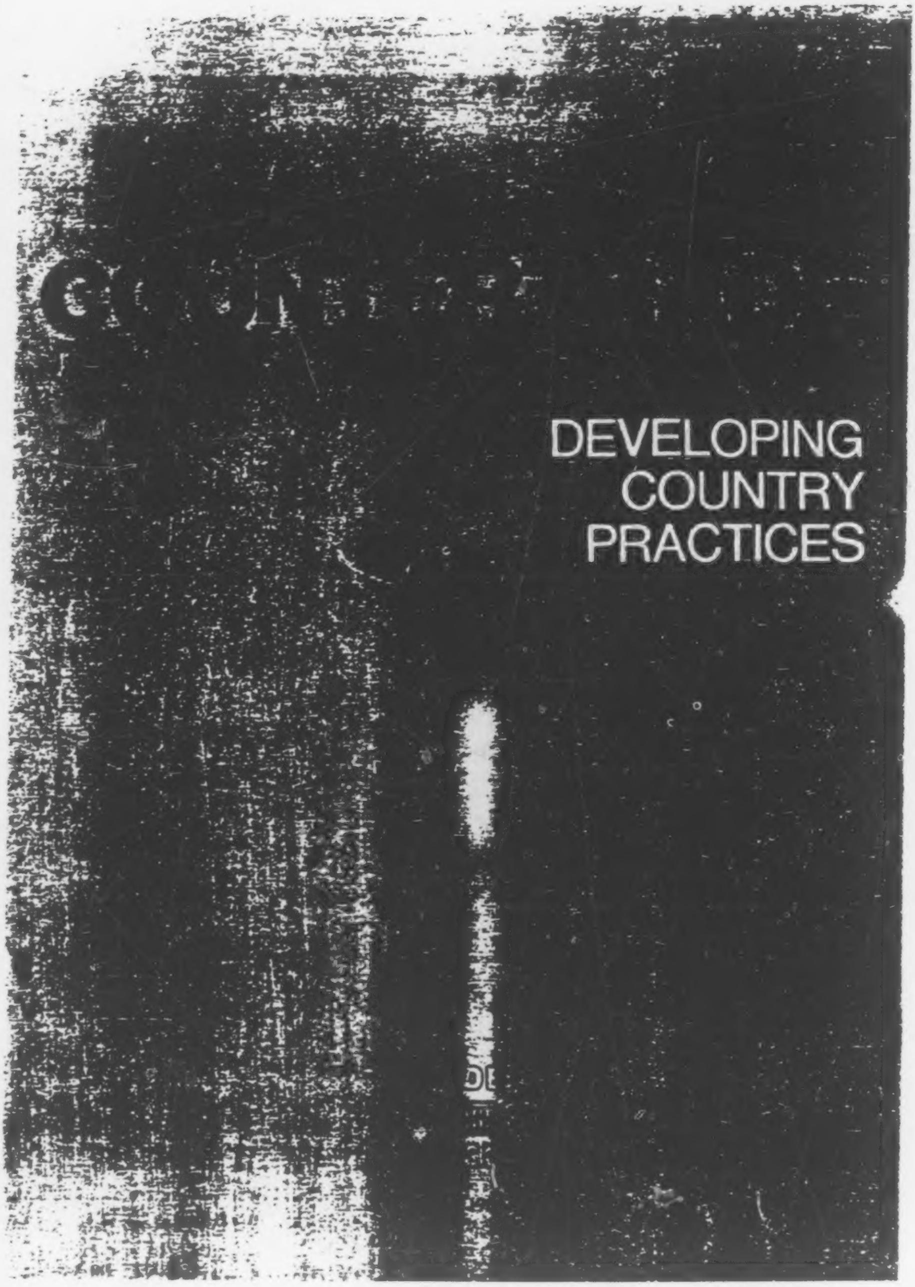

DEVELOPING
COUNTRY
PRACTICES

Pursuant to article 1 of the Convention signed in Paris on 14th December, 1960, and which came into force on 30th September, 1961, the Organisation for Economic Co-operation and Development (OECD) shall promote policies designed:

- to achieve the highest sustainable economic growth and employment and a rising standard of living in Member countries, while maintaining financial stability, and thus to contribute to the development of the world economy;
- to contribute to sound economic expansion in Member as well as non-member countries in the process of economic development; and
- to contribute to the expansion of world trade on a multilateral, non-discriminatory basis in accordance with international obligations.

The Signatories of the Convention on the OECD are Austria, Belgium, Canada, Denmark, France, the Federal Republic of Germany, Greece, Iceland, Ireland, Italy, Luxembourg, the Netherlands, Norway, Portugal, Spain, Sweden, Switzerland, Turkey, the United Kingdom and the United States. The following countries acceded subsequently to this Convention (the dates are those on which the instruments of accession were deposited): Japan (28th April, 1964), Finland (28th January, 1969), Australia (7th June, 1971) and New Zealand (29th May, 1973).

The Socialist Federal Republic of Yugoslavia takes part in certain work of the OECD (agreement of 28th October, 1961).

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ÉCHANGES COMPENSÉS
PRATIQUES DES PAYS EN DÉVELOPPEMENT

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In January 1984, the Executive Committee at its 43rd Special Session noted with concern the recent increase in requests for countertrade presented by a number of developing countries. It asked the competent bodies of the Organisation, including the Trade Committee, to examine the importance of this phenomenon, the motivations of the developing countries involved and the implications of a possible continuing development of these practices.

This Secretariat report was prepared for the Trade Committee and its Working Party and discussed by them.

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INTRODUCTION AND GENERAL CONCLUSIONS

The increase in trading based on barter is currently attracting attention. Many articles have appeared in the press reporting that a growing number of countries – mainly developing countries – are requiring to a greater or lesser degree their foreign suppliers to purchase national products. Western businessmen are organising themselves to meet this new situation by creating or extending services specialising in the selection and redistribution of compensation products. In some OECD Member countries, governments have set up public or semi-public agencies to brief national firms on these new practices. Other countries are currently considering the establishment of such agencies and discussing the responsibilities that would be assigned to them.

This phenomenon has also been discussed within the Organisation. It was recognised that the spread of these practices gave reason for concern, since it reflected a pursuit of bilateralism which would amplify the distortions currently affecting the multilateral trading system. It would also contribute to delaying the implementation of adjustment measures which are often highly desirable. Since there is a lack of knowledge on countertrade transactions, the Secretariat was asked to study in greater detail the nature of this trade and the countries and sectors where it is developing. It was also requested to identify the reasons which led some countries to require compensation for their imports, so as to determine whether these reasons were based on cyclical or structural factors. The Secretariat was finally asked to show, on the basis of pertinent economic arguments, whether or not countertrade operations are really in the interest of those countries which practice them.

This report constitutes a response to the mandate the Secretariat was given. Since it is extremely difficult to collect reliable and complete information on developing countries' countertrade transactions[1], this paper should be considered a first attempt at describing the nature and extent of the problem. The study's main conclusions are set out in Section V. Here we shall confine ourselves to the following general comments.

As a consequence of the considerable publicity at present being given to countertrade – hailed by some as a way of reactivating trade between countries that lack the resources to pay – many observers overestimate the importance of the real as well as the potential role of countertrade transactions. While it is undeniable that such practices have spread rapidly over the past few years, it is only fair to say that for the time being they are of no more than marginal importance in international trade as a whole. What would become a matter of increased concern would be the persistence and continuing extension of these practices independently of the economic reasons for their recent proliferation (e.g. the worldwide economic recession and the liquidity crisis experienced by a number of countries). That would lead many countries to succumb to the temptation of a return to bilateralism in trade, disregarding the inevitable additional economic costs of such trade, which would be less transparent and less rational than in a multilateral system of access to markets and financial payments, where there is freedom to choose the best supplier.

It will be noticed that in the developing countries countertrade transactions are mainly handled by State agencies, while in Member countries these transactions are generally negotiated and carried out by private enterprise, with no government intervention. It is thus not absolutely necessary for OECD Member governments to contemplate any specific control or regulation of countertrade transactions since usual trading rules can be applied. It is nevertheless true that rules applicable in the multilateral framework contain no express mention of trading based on barter.

Given this statutory and regulatory vacuum, it is essential that the choice of compensation as a means of promoting trade be made in the full awareness of its direct and indirect effects. While it is usually untrue that the countries requesting countertrade have no alternative, it is, on the other hand, perfectly true that the alternative options are, for economic or political reasons, more difficult to implement *in the short term*. It is on the disadvantages *in the longer term* of a trade policy based on countertrade that information is lacking. An objective analysis of the direct and indirect consequences of such practices, highlighting the additional economic costs they entail and the danger that they may weaken the multilateral trading system, would show countries or firms attracted by countertrade that it is often not the best way to bring sustained growth of exports and improve the balance of trade.

I. SOME GENERAL COMMENTS ON COUNTERTRADE

Trading practices based on barter or on variants thereof have always existed. They tend to increase when economic difficulties disrupt international trade channels. However, they decline at times of greater trade liberalisation, giving way to multilateral trading and financial settlement practices which are more flexible and efficient. Since World War II the decline of transactions based on bilateralism has been confirmed in the OECD countries, as well as in those other countries which have based the conduct of their foreign trade on the principles of the market economy and economic liberalism.

However, there remained one area – the East European state trading countries – where the propensity to bilateralism continued to be a major factor in foreign trade relations. As from the 1960s the East European countries expanded their countertrade transactions with various developing countries. These practices replaced, in part, the bilateral clearing agreements which the developing countries in UNCTAD had called upon their partners to abolish. From the mid-1970s on the East European countries also strongly increased their requirements for compensation vis-à-vis the OECD countries. This corresponded to the sharp rise in their debt service burden and a wish to reverse their chronic trade deficits with the OECD area. Since 1979 the Organisation has carried out studies on the nature of the problem posed by the proliferation of East European countries' requests for compensation. This work opened the way for joint action by Member countries in the bilateral and multilateral fora in which the East European countries participate, the aim being to persuade the latter to temper their requirements and ultimately to abandon them.

While countertrade is fairly well documented where East-West trade is concerned, very little information is surfacing on what is happening in other areas. It has been known for some time that there are bilateral transactions between OECD countries that contain certain features of countertrade. These occur in specific sectors: "industrial compensation" (also referred to as "trade offsets") in respect of sales of aeronautical or military equipment, whereby the buyer country is entitled, in exchange, to assemble part of the equipment locally, or to deliver to the supplier local products and services which may or may not be directly linked to the equipment purchased; the barter of food for strategic raw materials, a practice followed by the United States on various occasions under a special regulation (PL 480). Although there have recently been rumours of requests for compensation in respect of ordinary trade transactions between OECD Member countries, the Secretariat has not been able to verify these allegations. It would nonetheless be surprising for there to have been any large-scale expansion of countertrade transactions between OECD countries in the recent period, since several factors are absent which experience has shown are usually present whenever this type of transaction is on the increase.

First of all, unlike the East European countries and the governments of a number of developing countries, OECD Member country governments do not encourage countertrade, either officially or unofficially[2]. Second, as noted above a correlation seems to exists between countertrade and commercial transactions of public bodies. Although it is difficult to determine the share of intra-OECD trade carried out through government purchases, the proportion is fairly low and at all events lower than in many countries in other geographical areas. A considerable part of trade between Member countries is decentralised and takes place through private enterprises which feel no incentive, from an individual standpoint, to operate through compensation when more efficient channels are available. Thirdly, Western firms usually find a buyer for their products through the market mechanism. They are not obliged to push their sales through tying them to imports. The fourth factor inhibiting the expansion of countertrade within the OECD area is a fairly widespread feeling that these practices run counter if not to the letter at least to the spirit of the rules and multilateral agreements that define the legal framework for trade between Member countries[3].

The dissuasive factors described above play a smaller if not non-existent role in most developing countries. As other Secretariat studies have shown, these countries' trade policies are in the majority of cases more complex, more changeable, less transparent and less subject to multilateral regulations than those of Member countries. Moreover, state intervention in foreign trade tends to be more common and more active. Lastly, with the fragility of many of these countries' economies, governments exercise close control over the factors liable to influence their macro-economic equilibrium. There is, too, the developing countries' wariness of international markets which they suspect are manipulated by the Western countries.

Countertrade transactions therefore find favourable terrain in the context of the developing countries. It is perhaps even surprising that they did not develop earlier and in a more extensive way[4]. Although it is impossible to draw up with precision a list of developing countries that practice countertrade – very few of them have taken a position publicly on the subject and most of them follow these practices only occasionally – it cannot be disputed that the number of countries concerned has increased appreciably over the past few years.

A recent survey of a group of American firms (conducted by Willis A. Bussard under the aegis of the National Foreign Trade Foundation) shows that in 1972 15 countries in all, most of them East European, requested countertrade. By 1979 the figure was probably 27 with the inclusion of many Central and South American countries. By 1983 it had risen to 67, with countries from all geographical areas represented, and possibly 88 if those countries (mainly OECD Members) are added whose countertrade requirements relate solely to contracts for military supplies. The expansion of developing-country requests for compensation would thus seem to have started around the mid-1970s and recently to have gathered considerable momentum.

In the Table below the Secretariat lists the developing countries which, according to the data it has collected, *display or may have displayed an interest in countertrade in recent years*. The criterion adopted was fairly flexible since the official position of most of these countries, the actual proportion of countertrade in their foreign trade, the frequency of their requests and how far they are successful could not be ascertained. About 50 developing countries would seem to satisfy this broad definition. But if the information the Secretariat has gleaned from the press on *specific instances of countertrade transactions actually negotiated or implemented* is taken as the selection criterion, then the number of developing countries falls to 20 at most (see Annex II)

DEVELOPING COUNTRIES REPORTED TO HAVE SHOWN AN INTEREST IN COUNTERTRADE

AFRICA	Algeria, Angola, Congo, Egypt, Ghana, Guinea, Ivory Coast, Kenya, Liberia, Libya, Morocco, Nigeria, Senegal, Sudan, Tanzania, Tunisia, Zaire, Zambia, Zimbabwe.
LATIN AMERICA	Argentina, Brazil, Colombia, Costa Rica, Cuba, Dominican Republic, Guatemala, Guyana, Jamaica, Mexico, Peru, Trinidad, Uruguay, Venezuela.
ASIA	Bangladesh, Burma, India, Indonesia, Iran, Iraq, Jordan, Malaysia, Pakistan, Philippines, Qatar, Saudi Arabia, South Korea, South Yemen, Thailand, Vietnam. [China – Israel]
EUROPE	Malta, Yugoslavia.

II. THE SHARE OF COUNTERTRADE IN WORLD TRADE

From a technical standpoint countertrade takes a wide variety of forms. Although the original object of barter systems was to avoid the use of money, transactions involving the exchange of goods with no accompanying financial settlement whatsoever are in practice very rare. To achieve the main aim, namely to match the value of the goods or services exchanged on each side, countertrade transactions usually combine several elements: a variable and negotiable percentage of the countertrade transaction, staggered transactions, partial or total financial settlement, elective third-party participation, resale conditions for the products involved and so on. Although it is possible to classify countertrade according to a number of key characteristics, each transaction often presents unique features.

The classification drawn up to analyse countertrade transactions with the East European countries may serve as a general framework for consideration of similar transactions with other OECD trading partners. The many variants of countertrade are usually divided into two main categories:

a) commercial compensation transactions and

b) industrial compensation transactions

The definitions most commonly used are summarised in Annex I. For a fuller description the reader is referred to "East-West Trade: Recent Developments in Countertrade", OECD 1981 – Part I, Section 3.

Countertrade operations by the developing countries known to the Secretariat are seldom large-scale and long-term industrial compensation transactions involving buy-back of the goods produced. In virtually all cases they are *commercial compensation* transactions. This predominance of transactions under counterpurchase category has a drawback that was pointed out in the Secretariat analysis of compensation transactions with the East European countries. Since commercial compensation transactions as a rule have a comparatively low unit value, they do not enjoy the same exposure in the press as the major industrial contracts. On the other hand, it is known that international trade statistics do not ventilate goods traded under compensation arrangements. It is hence nearly impossible to inventory these commercial transactions and to ascertain their precise characteristics.

The problems that arose when the Secretariat attempted to quantify the value of countertrade with the East European countries are even more acute when developing countries are involved. In the case of the East European countries, it was possible to identify a certain volume of industrial compensation transactions, which provided a basis for extrapolating the value of commercial compensation transactions on which no detailed information was available. This method cannot be used in the case of the developing countries.

Because of these gaps in the statistics it is impossible either to confirm or to refute scientifically the figures put on the share of countertrade transactions in international trade, particularly in the press, which situate these transactions as representing between 20 and 40 per cent of international trade. Some experts predict that in about ten years' time at least one-half of international trade will be carried out in the form of countertrade. Considerably lower figures are put forward by the IMF and GATT: 1 per cent and at the most 8 per cent of world trade, respectively.

While the range between these estimates may be due to questions of definition, common sense tells us that the higher figures are inflated. If they were correct, trade to the value of between $360 and $720 billion per year would be in the form of bilaterally tied transactions. A figure on this scale would be bound to affect firms engaging in international trade to such a degree that it would provoke reactions that could not fail to attract attention. With such a volume of countertrade transactions, turnover of trading agencies or companies acting as intermediaries to find outlets for compensation products would have soared. There would also very likely have been considerable development of commercial law focussing on the drafting and litigation aspects of countertrade contracts. Admittedly activity in all these areas has expanded over the last ten years or so but it does not seem to be in proportion with the volume of bilateral trading transactions the above estimates would suggest.

Taking the analysis further, an attempt may be made to formulate assumptions on the proportion of countertrade in inter-regional trade in using the line of intuitive reasoning outlined as follows:

i) Firstly, the amount of countertrade transactions in the total trade of *industrial areas* which, it will be recalled, account for over 60 per cent of world trade, can be estimated. A reasonable figure would be 15 per cent of this trade with the East European countries, an assessment borne out by the various studies of East-West countertrade [$15.6 billion on the basis of 1983 world trade figures published by the GATT and corrected, where appropriate, along the lines of the exclusions mentionned below in iii)]. It is unlikely that countertrade accounts for as high a percentage of trade between the industrial area and the developing countries. Western oil imports are paid for virtually in their entirety in foreign currency. Although they have increased lately, the few instances of countertrade transactions reported with oil producers involve only relatively small amounts[5]. A plausible assumption is that trade in both directions represents 2 per cent at most (some $4.3 billion). The proportion of countertrade transactions with the other developing countries (non-oil exporters) is probably higher, possibly of the order of 5 per cent at most of trade with the OECD area (some $16.6 billion)[6]. Finally, it seems highly unlikely that countertrade between the industrialised countries themselves represents several tens of billions of dollars, given the dearth of information on these transactions: a figure of 2 per cent of trade between industrialised countries can be ascribed to them ($15.7 billion), which is placing it fairly high;

ii) Information appearing from time to time in the press on countertrade transactions very often concerns *trade among the developing countries or between them and the East European countries.* Taking oil exporters and the other developing countries together, it could be assumed that at most 10 per cent of intra-developing country trade[7] takes place as countertrade ($12.5 billion), compared with 30 per cent of their trade with the East European countries ($14.2 billion);

iii) *Trade among the East European countries* should be excluded from these estimates because it takes place under bilateral clearing arrangements which are of a different nature. Similarly, it would seem reasonable to exclude *clearing* trade between countries belonging to other geographical areas estimated by the Secretariat at a total of $30 billion. The value of world trade to be excluded is thus about $130 billion in total.

Summing the estimates set out above gives a value of about *$80 billion* which would be the *maximum estimate* for the value of world trade in 1983 in the form of countertrade, or *approximately 4.8 per cent of world exports* (excluding trade among the East European countries and trade under clearing arrangements). Leaving aside trade with the East European countries, a figure of approximately $50 billion is obtained for countertrade between countries which, barring a few exceptions, operate according to market economy principles.

Three comments should however be made:

i) Some developing countries are more deeply involved in countertrade than others, either traditionally or because they trade more extensively with the East European countries. In these particular cases, the countertrade percentages may be well above the average[8];

ii) The amounts for *potential* countertrade estimated empirically as above are considerably higher than the sums that would be computed from the transactions listed in Annex II;

iii) Although the apparent proportion of world trade in the form of countertrade seems finally significantly lower than the figures given in the press, the *absolute* amounts involved have apparently tended to increase fairly rapidly in the last few years.

III. EXPORTERS' REASONS FOR RESORTING TO COUNTERTRADE

In order for a commercial trade transaction to take the form of compensation, the trading partners should *in principle* arrange that both their respective requirements and transaction values coincide. Such matching is an exceptional occurance in a diversified economic system with highly developed specialisation. It will therefore be difficult to avoid unloading on the market part of the goods traded within countertrade operations, thus involving third parties, either as end purchasers or as middlemen. It follows that trade through the medium of countertrade transactions involves procedures that are more complex, more risky and ultimately more costly than those entailed by two entirely separate transactions financed in the conventional way. Why therefore do governments and the public economic agents choose to have recourse to such a form of international trade?

Is it a question of imitation? Certainly there is a similarity between the regulations introduced in 1981 by Indonesia and those of Romania a few years earlier. Are developing countries following the example of the Eastern countries which tend to give the notion of price a secondary priority and to favour bilateralism for ensuing stability and balance of mutual trade? It is indeed with Eastern countries that several developing countries concluded their first countertrade transactions during the sixties and the seventies. According to the OECD Development Centre study already mentioned, these transactions were probably not on the whole disadvantageous for the countries concerned[9]. The developing countries nonetheless put collective pressure in the 1970s on the East European countries – and more particularly on the Soviet Union – to abandon their requirement of balanced trade and accept settlement in convertible currencies. This had some effect since it was followed by a decline in East-South barter and clearing arrangements during this period. In 1982 the Soviet Union maintained clearing arrangements with only six developing countries: Afghanistan, Egypt, India, Iran, Pakistan and Syria.

The Soviet Union, however, continues to display a preference in trade with the developing countries for bilateral balancing and a settlement system avoiding use of Western currencies. A recent document presented to the UNCTAD[10] by a Soviet expert ascribes the buoyancy of Soviet Union trade with several developing countries to the existence of clearing arrangements. The study advocates barter, compensation and clearing trade transactions on the grounds that they make it possible to increase the volume of trade, improve its structure, regularise two-way flows, safeguard convertible currency reserves and promote independence vis-à-vis the unstable Western monetary system. It would therefore seem that the Soviet Union is using the financial difficulties of many developing countries as a pretext for reviving its traditional arguments in favour of bilateralism. As will be stated later on, the developing countries do not seem to have adopted the Soviet reasoning for themselves even though countertrade transactions have recently shown some increase in the context of East-South trade.

The motivations of the developing countries that favour countertrade are based on less dogmatic concerns than is the case with the East European countries. Most of the developing countries seem presently to hesitate giving an official status to their countertrade demands. They do not feel therefore obliged to provide justifications based on theoretical considerations for measures or directives which, with few exceptions, are not made public and are rather based on opportunistic motivations. Certain comments expressed on the countertrade policies of one or other developing country suggest nevertheless that they may be based on motivations that are not exclusively conjunctural. Such as the view that compensation is a mode of trading which might be better suited to the economic situation of developing countries; the desire to break loose from dependence vis-à-vis the industrialised countries which are accused of arbitrarily setting the prices of primary products might also be a factor[11]. Alternatively, countertrade might be seen as a means for countries with little economic weight to obtain greater reciprocity from their trading partners.

The developing countries have to date not expressed however a collective view on countertrade in the same way as they have for other international trade practices. There is no evidence that their interest is presently based on economic or political considerations. No reference is made to countertrade in the body of theoretical and practical concepts drawn up by the developing countries with a view to reform the world trading system. Consequently the question of the possible use of countertrade practices in North-South trade and their advantages and disadvantages for the countries concerned has not yet been raised in the multilateral fora (UNCTAD or GATT) where North-South issues are discussed.

The developing countries therefore appear to enter into countertrade transactions in an ad hoc manner. Only two countries (Yugoslavia and Indonesia) have so far established an official policy incorporating general regulations on countertrade. Three or four other developing countries have laid down regulations which – while not making compensation mandatory – provide for it in some circumstances. Other developing countries are reputed to be in favour of compensation and to have issued government departments with directives to this effect, though these are not published. In some developing countries officials occasionally state an interest to develop countertrade.

Governments in many developing countries do however seem to be reluctant to embark upon any *systematic* countertrade policy. They tend rather to confine it to a limited number of firms or agencies so as to be able to monitor these transactions more closely, making sure, in particular, that countertrade promotes additional exports and does not reduce traditional trade flows. Furthermore, certain developing countries, especially in Latin America, seem to be afraid that their private firms may make use of countertrade transactions to cover up certain fraudulent practices, for instance, under-declaring imports so as to pay less duty, or over-declaring exports so as to be able to make illicit capital transfers. This would explain why these countries maintain fairly strict controls over such transactions, which are subject to a licensing system involving submission to an administrative body whose task it is to check that various criteria are respected (see, especially, Colombia). Other developing countries seem to confine countertrade to transactions under direct government control.

One should not, however, rule out the possibility that the developing countries may be allowing a parallel trading system to evolve, one which could provide some kind of marginal alternative when current exports did not progress as planned, or when the difficulty of penetrating certain markets acts as an incentive for trying to bring more direct pressure on potential customers. Discussions and studies are, moreover, taking place in various fora where developing countries meet, with a view to considering whether countertrade may be of advantage to those countries. At a recent LAIA (Latin American Integration Association) meeting, 11 Latin American countries are reported to have agreed, alongside other trade integration measures, to encourage bilateral compensation agreements. The growth of these practices in Asia is currently under study by ESCAP (Economic and Social Commission for Asia and the Pacific), while UNCTAD is reported to have undertaken a study of countertrade as a means of promoting South-South trade, in particular between the state trading bodies whose setting up is proposed in the context of a programme of economic co-operation among developing countries.

Occasionally, though infrequently, OECD exporters or Western firms operating in the developing countries propose compensation as an option. The reasons prompting Western economic agents to do so should hence also be taken into account if one is to understand why these practices are gaining ground.

A. Developing country motivations

i) Countertrade as a consequence of the liquidity crises triggered by external macro-economic imbalances

This motivation seems to be the easiest to demonstrate. Temporal correlation can be observed between the worsening of liquidity crises in Third World countries and the emergence of proposals for commercial compensation.

In the case of Brazil and Mexico, external imbalances began to worsen in 1979 and requests for compensation seem to have increased shortly thereafter. The coincidence is even more apparent in the case of Indonesia and Malaysia. For both countries current account imbalances became more marked as of 1981. It was at the end of that year that Indonesia made compensation mandatory for government procurement. Malaysia acted somewhat later, between end-1982 and mid-1983. Earlier it had attempted to improve its bilateral balance with the East European countries. The worsening of the Philippines' foreign payments position became much more pronounced in 1983 and it was towards the end of that year that information surfaced indicating that the Philippines were seeking to develop compensation with the East European countries; at present the country may be considering a similar line in its trade with the West.

A very large number of developing countries are currently having to contend with comparable economic difficulties (external imbalances, growing debt service burdens, a drop in demand for their exports and in primary product prices). Given their shortage of convertible currency resources, these countries are obliged to adjust through a steep cutback in their imports. Import licences are allocated according to national priorities set by the authorities. These measures generate disruptions of greater or lesser severity depending on the degree of rigidity of the system for rationing means of payment and the adaptibility of the domestic economy.

In such circumstances countertrade may be perceived as a way of imparting flexibility to a partly inflexible system, by marginally increasing import possibilities beyond the limits set by the authorities in accordance with the availability of convertible currency reserves. The complexity of countertrade transactions and the additional costs they entail do not constitute a disincentive since the economic agents are prepared to pay a sizeable premium to obtain intermediate goods, spare parts and foreign consumer goods for which there is strong domestic demand. In a situation where regulations are frequently changing and the outlook for the future is uncertain, transactors tend to disregard the fact that compensation is economically irrational in the longer term. In such a perspective, the short-term prevails over the long-term (see Section IV).

The liquidity crisis is sometimes so acute in certain developing countries that they become incapable of meeting their payments deadlines for industrial or civil engineering projects that were begun on the basis of over-optimistic projections of their export earnings. They then suggest to their foreign creditors that they take delivery of products against repayment of outstanding debt. For the creditor this solution may be preferable to suspension of payments, which would mean funding his losses, obtaining credit or bringing proceedings against the debtor. Several oil-producing countries (Iraq, Kuwait, Libya, Qatar) have recently offered to pay creditor countries – both developing and developed – in the form of oil. Poland has also apparently settled part of the arrears on its debt to Brazil in goods (oil, coal and sulphur). Broadly speaking, depletion of their convertible currency reserves has led many developing countries to put stricter controls over financial transfers. Certain types of payment have been suspended (e.g. the repatriation of disinvested capital), while others are delayed (especially commercial payments, payments for patents and licences, etc.). Many Western firms now find themselves with blocked assets and claims in developing countries. One way of unfreezing these sums is to transform them, through a countertrade procedure, into goods exported and sold for the creditor's benefit.

Should these liquidity crises prove to be a temporary phenomenon which the current adjustments and debt rescheduling arrangements will be able to solve in the space of a few years, recourse to countertrade ought also to be temporary. The outlook could be different if, as some observers believe, the imbalances that many developing countries are having to contend with are the reflection of structural phenomena. The scarcity of convertible currencies would in the latter case remain chronic and countertrade despite its high cost would continue to attract followers.

ii) Countertrade as a means of circumventing the trading problems caused by inconvertible and/or overvalued national currencies

The motivations that may come under this heading constitute another facet of the liquidity and solvency problems raised earlier. In many developing countries the national currency is either non-convertible or is maintained at an exchange rate which does not correspond to its market value. This exchange rate is almost invariably overvalued, in order to reduce the cost of imports. But exports are made correspondingly less competitive and domestic production is thereby discouraged. Countertrade transactions may be a means of correcting the distortions introduced by an unsuitable exchange rate in that they allow for a selective devaluation, on a case-by-case basis (see Section IV).

Furthermore, the non-convertibility of the national currency is conducive to the adoption of bilateral trading and financial arrangements which make it possible to refrain from drawing on convertible currency reserves. These are insufficient in almost all developing countries which prefer to keep them for priority uses. One option would be to make clearing arrangements with individual trading partners where this is acceptable. The clearing system is more flexible than countertrade since it allows across-the-board adjustment of trade balances on a deferred basis instead of requiring that balance be achieved on each transaction. But in bilateralising trade in its entirety, it sets the point of equilibrium at the level of the weaker partner. If an across-the-board clearing arrangement is not possible, compensation can serve as a partial clearing system.

The Secretariat has noted several instances where countertrade practices were provoked by the exchange control system in place (notably Mexico and Yugoslavia). Exporting firms are sometimes authorised to retain, provided certain conditions are complied with, a portion of the foreign exchange which is normally turned over to the Central Bank and to use it for their own purposes. Depending on the procedures laid down in these regulations, the transaction may or may not take the form of compensation. This is the case for example when a firm informs its foreign supplier that it will only be permitted to place an order if it can furnish proof of a sale. It will then be up to the foreign supplier either to make a direct purchase or to find a third party wishing to make such a purchase. The foreign exchange thereby obtained will be frozen in an account and subsequently used to pay for the goods acquired by the firm abroad.

iii) Countertrade as a means of increasing and regularising commercial trade flows

Developing countries – and chiefly those dependent on earnings from sales of primary products – complain of the instability of the markets to which they export. They are endeavouring to have measures adopted by the international community that are aimed either at limiting fluctuations in prices of primary products or at offsetting the effects of these fluctuations on their convertible currency earnings. Quite possibly they perceive countertrade transactions, which enable them to exchange their primary products for essential imports, as a means of imparting greater stability to their trade.

In fact, developing countries are interested not so much in compensation itself as in medium and long-term sales contracts to provide stable and guaranteed outlets. In this they resemble the centrally planned economies which seek to avoid changing their planned objectives in accordance with cyclical fluctuations in the market economies. In the case of the East European countries proposals for compensation are built around what they more readily term "industrial co-operation agreements". One of the commonest forms thereof is the buy-back agreement under which the value of the purchase of Western equipment is paid for with deliveries over several years of part of the output of the new plant. The Soviet Union, which was the prime initiator of this type of transaction, has signed a number of such agreements with developing countries, e.g. Egypt and India.

It is not possible to state, however, whether this motivation plays a large part in the reasoning of the developing countries. As noted earlier, countertrade transactions with developing countries based on buy-back are not very common, except for Yugoslavia and two or three of the more industrialised developing countries in their trade with the East European countries. While the developing countries do indeed frequently offer primary products for compensation, such sales seldom take the form of long-term transactions comparable to the type of industrial co-operation the Soviet Union is seeking to promote. The few known cases involving OECD countries concern transactions aimed at exploiting mineral resources in the developing countries. Here the aim of countertrade is not only to secure stable outlets for producing countries but also to counterbalance and guarantee the heavy investment with long amortization periods required to open mines.

Countertrade may also be used with the objective of reducing a trade deficit vis-à-vis a given trading partner. It is a way of putting pressure on that partner to increase its imports. Thus Brazil made it known in May 1984 that it would reduce its oil imports from supplier countries that do not buy enough Brazilian products. Malta is also thought to have threatened France with halting imports if its deficit with France was not reduced. See also, in Annex II, the information about Jordan.

It has been wondered whether countertrade might not be an attempt on the part of the developing countries to increase or get round import obstacles on the OECD countries' markets. Such a policy would not be very effective since goods imported under cover of countertrade transactions are considered, once they cross the frontier, to be ordinary goods and are subject to the same regulations. Rules of origin and, where applicable, import restrictions will be placed on them in the same way as on direct imports. At the very most the developing countries might hope that the Western firms to which they offer goods subject to restrictions might plead their case for an easing of protectionism with their own national authorities.

iv) Countertrade as a means of improving a competitive position

Analysis of countertrade transactions undertaken by developing countries shows that the general aim common to most of these operations is to export a product which is difficult to sell for cyclical or structural reasons. Inasmuch as the effect of countertrade is to market products (or services) which would not be marketed under "normal" trading arrangements, this type of transaction enhances the position of the seller vis-à-vis his competitors, though the question must be asked whether this "positive" effect is not in part illusory.

First of all it is observed that compensation has been used on a number of occasions to export *primary products* that were coming up against a saturated market. By obliging a foreign trading partner to take up a consignment of these products, whether for his own use or for resale to a third party, the producing country obtains a greater market share to the detriment of other producers. This result may seem advantageous to those developing countries which rely on the export of primary products, particularly those which are chronically overproduced. One of the advantages of countertrade transactions is that they enable the seller to lower his prices in a clandestine manner without officially contravening producer agreements (international commodity agreements or producer cartels) or setting off a reaction on international commodity exchanges[12].

The Development Centre study on the incidence of barter in the developing countries from the 1950s to the 1970s shows that the goods offered by the developing countries were made of such primary products as cotton, coffee, sugar, rice, iron ore, bauxite, oil and rubber. A more recent study by the United States International Trade Commission[13] indicates that the United States imports chiefly ores and metals in countertrade arrangements with developing countries, the two most important commodities being bauxite and iron ore. Countertrade may also be used to run down stocks of agricultural products or to adjust the level of strategic stocks without affecting international prices. The initiative for this type of transaction has sometimes come from the West.

Another developing-country objective may be to foster exports of *non-traditional products*. The countries concerned tend to be producers of primary products anxious to diversify their exports and which are at an early stage of industrialisation. Their manufactured products are little known internationally or are in keen competition with those of other developing countries with better market penetration. These countries generally present their suppliers with a list of products from which to offset purchases. They sometimes attempt to make these offsetting sales additional to their normal exports of the same products. Other developing countries, while not having an official list, seek unofficially to channel countertrade transactions towards sectors whose exports they wish to promote.

A third objective, which partly overlaps with the first two, is to disguise the offer of goods on *preferential terms* whether this be in the sale part of the transaction, the purchase part, or both. These may take the form of subsidies or more favourable terms than are usual which the countries concerned do not wish to be known by other trading partners. Similarly, exports at dumping prices are probably easier to conceal in the framework of countertrade transactions when a third party is responsible for marketing the products and when these sales channels are more complicated.

v) Countertrade as a component of development policy

Some developing countries which are reputed to have requested compensation have not however been very seriously affected by the current economic problems described in Section *ii)*. Their foreign payments positions have not deteriorated to a point where a shortage of currency holdings has forced them to cut back heavily on imports. Cyclical movements in primary product prices may have had an influence in some cases, though probably not a decisive one given the diversification of their exports. This would suggest that their requests for compensation have been prompted by other considerations, possibly bound up with longer-term aims.

This might conceivably apply to Malaysia. The latter country has not encountered serious problems in balancing its payments overall though its current account position began to deteriorate in 1980. Its external debt is not excessive and can be spread over six export products (tin, rubber, palm oil, timber, oil and gas, and pepper) the risks generated by price fluctuations. In the case of Malaysia, its interest in countertrade transactions would seem to have coincided with the disappointments of an overambitious industrialisation policy. The government encouraged the development of heavy industry (cement, aluminium, automobiles) but as of 1983 the burden on the budget proved too great. The projects were suspended though the government's medium- and long-term industrialisation objectives were probably not abandoned. In this context countertrade can be perceived *as a means of saving on resources which may alternatively be assigned to major public industrial projects*. This would tally with the fact that countertrade requests originate solely from government or semi-government importing bodies. Likewise in Indonesia it is government procurement that is subject to the compensation requirement. The measure was introduced at a time when a series of major investment projects were postponed because of financing problems due to a fall in budget receipts.

It may also be asked whether the underlying objective of some countertrade proposals is that of *transfer of technology*. This is frequently the case of the East European countries, leading to the offers of "long-term co-operation" referred to earlier. In their features these transactions sometimes resemble international sub-contracting. The hope is that the Western party, whose objective is to obtain regular deliveries of quality products, will provide up-to-date technology, set up and monitor production and subsequently transfer additional technology and know-how to ensure that the goods produced remain competitive.

However it does not seem that the developing countries are using compensation for this purpose, at least where Western countries are concerned. They probably have done so with certain East European countries which have supplied factories against credit in return for buy-back of part of their output (Soviet Union with Egypt and India). Among cases of North-South countertrade known to the Secretariat no instance of technology transfer has been cited as the prime aim. It should be pointed out though that there is a big difference between the East European countries and most developing countries in that the latter accept direct investment from the West. Developing countries often impose conditions for these investments which may relate to technology transfer, the dissemination of patents or manufacturing processes, the increased use of local inputs and the export of a part of output. Similar obligations in the form of compensation would create duplication without bringing any notable advantages from the standpoint of development policy.

B. Motives ascribable to Western partners of the developing countries

The Secretariat's study has shown that in some circumstances it is the Western exporter who takes the initiative of proposing to his developing country partners a trading arrangement based on compensation. This is for a number of reasons.

The most frequent reason is the introduction by developing countries of import control measures which have the effect of impeding normal trade flows or making them more uncertain, in particular when foreign currency or licences are allocated on an irregular or discretionary basis. Western exporters are liable to find themselves excluded from these markets for an indefinite period when the products they sell are refused import licences. Exclusion from a market, even if temporary, can have very harmful consequences for many exporting firms. A way out is for them to transfer production to the countries that restrict imports, provided the market is of sufficient size and inputs can be obtained locally. But manufacturing on the spot is not always economically viable. One solution might therefore be to negotiate an import quota with the government of the country that imposed the controls in return for commercial advantages of equivalent value, i.e. the option to purchase local products.

An illustration of this type of approach may be found in the experience of a large European food manufacturer. According to the management, this firm does not regard countertrade as an end in itself and would prefer to do without it. However, it manufactures a wide variety of food products in 280 factories located in 55 different countries. Over 90 per cent of its turnover is derived from products manufactured in the country of sale and consumption. Nevertheless, some finished or intermediate products have to be imported because, for reasons of efficiency, their manufacture cannot be decentralised. Since several of the countries where the firm is established have encountered economic and monetary difficulties in the last ten years or so, it has increasingly had to resort to countertrade transactions and has set up a special management unit for this purpose at its head office. The firm cites the following reasons in this context: to enable some of the factories relying on imported components and packaging, machinery or spare parts to operate continuously; to maintain market shares and the presence of brand names in countries that have interrupted normal imports; to develop new markets for its products in countries where there is no possibility of penetration by other means; to facilitate payment of dividends, royalties, etc., deriving to the parent company; and to create a favourable business climate for itself in the country in question.

Another example is provided by a North-American manufacturer of agricultural equipment which found that its traditional Latin-American markets were shrinking because of customers' difficulties in obtaining foreign exchange. With the recession in the Western countries, the firm was turning to developing-country markets where demand was not saturated. Though the demand was there, the means were not. As in the above example, the firm set up a countertrade department specialising in the purchase and resale mainly of agricultural products (coffee, tomatoes, canned goods).

Western firms also propose compensation when financial settlements are blocked owing to the tightening of exchange controls in the partner country. They sometimes suggest that an account be opened in a third country in which would be recorded the value of the transactions of both the firm and the debtor country. The assets side would show the purchases of countertrade products which would serve to offset liabilities and even to keep up the flow of deliveries which would otherwise have been suspended owing to non-payment.

The initiative may also come from Western trading companies which attempt to make up for the "disorganisation" of countertrade in the developing countries. The administrative procedures involved in finalising countertrade transactions are habitually lengthy and complex, particularly where no official regulations exist in the matter. This is the case in certain Latin American countries like Brazil and Mexico, where requests for compensation are submitted by the private sector. Other developing countries, particularly in Africa, are just beginning to display interest in compensation but their governments lack both the trading experience and skills needed to negotiate viable transactions. Western trading companies and some US banks using a new piece of American legislation (Export Trading Company Act – 1982) which enables them to engage in commercial transactions, have offered to advise a number of developing countries on how to organise countertrade transactions. They draw attention to opportunities for selling to their customers and to their ability to organise the financing of such transactions. The trading companies also suggest that the authorities of the countries concerned grant them clearing-house status for the products offered in exchange for their customers' exports. In this way countertrade transactions are partly multilateralised and in some cases compensation credits may be transferred from one customer to another.

Lastly, it would seem that compensation has become a factor in competition among Western firms to win foreign markets. Negotiations with a view to obtaining major capital contracts have become extremely difficult with the increasing scarcity of such contracts, growing financing problems and the demands of customers who are conscious of the strength of their position. Success hinges not so much on the technical value of the equipment or processes offered as on a set of ancillary factors enabling the lowest possible apparent cost to be put forward. Efforts usually centre around the financing of the project. The offer to purchase local products is an additional advantage proposed to the buyer which, if the other sellers do not offer similar terms, may result in a contract being awarded.

Organising countertrade transactions is both delicate and risky, especially for firms wishing to maintain high product quality and which cannot in consequence absorb second-grade local products. Such firms have to turn to a trading company or take on the task themselves. Moreover, experience shows that it is difficult to revert to the normal pattern of trade and financial settlement once countertrade arrangements have been set up with a partner country.

IV. IS COUNTERTRADE A VIABLE SOLUTION?

The greater recourse to countertrade operations by developing countries, whether initiated by their own public or private enterprises or encouraged by Western firms, would seem to underscore their belief in the use of this form of trade to secure particular advantages. It is important however to assess *what type* of advantages these might be, *to whom* they would actually accrue and whether or not they would be of *lasting value*, in addressing the question of whether or not countertrade is a viable solution for the developing countries. In this context it would seem useful to distinguish between the interests of the public as opposed to the private sector and considerations of a short-term nature from those in the long-term.

i) *Short-term considerations*

In the short term, in the context of the macro-economic constraints that characterize economic transactions in most developing countries where distortions are often present in prices, markets and particularly exchange rates, countertrade may be viewed as a practical means of introducing flexibility into an otherwise rigid economic system. Countertrade operations may provide the possibility for carrying out trade in a situation where the price system no longer allows realistic appraisal of the goods in question and consequently where the assignment of a shadow price is necessary, whether this be in terms of a new price (that specified in the countertrade arrangement) or in terms of allocation through physical quantities of goods. Countertrade in this situation operates as a *selective devaluation* for exports. It represents the equivalent of an export subsidy plus an import tax. But contrary to a devaluation which operates across the board for all trade transactions, countertrade operations produce a selective devaluation which operates case by case in function of the agreed transaction. The exporter of the country with the over-valued currency accepts in such a case a discount on the price of the item at the official exchange rate. As each transaction carries with it a distinct price, this means that in a situation where several countertrade transactions have been negotiated within or by a single country, the effect produced may be similar to that of a multiple exchange régime.

From a short-term economic point of view, voluntarily engaging in countertrade operations for individual traders may be a second-best solution in a situation characterized by the presence of such distortions as overvalued currencies and foreign exchange rationing. In such a situation private firms have no alternative except to operate within the constraints of a given market, and entering into countertrade operations may be beneficial in allowing them to overcome or bypass such constraints. The additional trade which takes place in this second-best situation can be viewed as improving domestic economic welfare.

For private firms the move to engage in countertrade transactions under conditions of instability in financial markets may prove to be the least expensive way of hedging against instability as well as overcoming price distortions. The uncertainty surrounding a potential trade transaction as concerns the price and the quantity of foreign exchange which may or may not be made available can be reduced through a countertrade agreement ensuring that both parties must provide and receive goods according to specified conditions of a written contract. Countertrade may allow firms to continue trading in situations where the economic policies in force may be such that rigid requirements to conserve or ration foreign currency holdings would have otherwise blocked the possibilities of sales. Countertrade transactions also allow the firm to conceal the fact that the sale takes place below its price (measured at the official exchange rate). For those firms in developing countries which sell products such as petroleum or other commodities under obligations for international price control, countertrade transactions allow the firms to sell at a concealed discount.

Even though countertrade transactions may be a practical solution to continue trading in specific individual situations, they represent an inefficient way of doing so and their disadvantages will become apparent if these procedures become generalised. The difficulties inherent in matching the needs of sellers and buyers (which must eventually resell) for totally unrelated products results on the aggregate in economic rigidities and heightened costs. These costs are made up of *transaction costs* which come from the search involved in matching buyer, seller and products, and the time and effort consecrated to the negotiating of such arrangements. Also relevant are costs derived from *restricted supply* which comes from the inability to choose the cheapest seller (except by a fortuitous coincidence) as the two transactions – import and export – must be tied. These rigidities and associated costs can only work to reduce the level of overall trade. Thus countertrade activities, while possibly benefiting private actors in individual transactions, when carried out on a large scale can only be welfare reducing for the country as a whole.

The supplementary costs of countertrade should however be compared with the expense an indebted developing country would have to incur if it tried instead to follow traditional multilateral trading practices. For certain countries, it may be very costly to obtain additional credits in the latter case since commercial lenders would prefer short-term commitments and request high interest rates. A countertrade deal may consequently be more advantageous. This will depend upon the premium it carries (made up of the margin incorporated in the exporter's selling price and/or the discount that might have to be accepted on the countertrade product) compared with the price of a direct import. At any rate, the country's overall endebtedness will not increase and its hard-currency reserves will not be affected by the deal. The latter point may have its value in a situation where agreements with creditors stipulate that a specified portion of hard-currency reserves must be earmarked for the servicing of debt. A country may attempt to elude this obligation in the short-term by channelling part of its export trade through a parallel circuit that is not registered in the books of the Central Bank.

During periods of macro-economic difficulties and implementation of austerity programmes, it may be tempting for developing countries to view countertrade operations as a means of conserving foreign exchange, either to fulfill requirements specified in loan agreements regarding minimum levels of reserve holdings, or to conserve scarce foreign reserves for essential imports. Countertrade transactions may be seen in this context as representing sales "additional" to those which would normally occur, and would thus be a way of continuing to trade without worsening the balance of trade. However this short-term reasoning which places the countertrade operation in a static framework is erroneous and misleading when the dynamics of trade relations are considered. Under the assumption that the implicit price of a countertrade deal is necessarily positive (otherwise no incentive would exist for the developing countries countertrade partner to accept the product in question, if he thought that resale/disposal were to prove impossible and a total loss), this implies that any countertrade product could have otherwise been sold *for some positive price, at some point in time*. The uncertainty involved over the price and the time of a future sale may however render the alternative of more immediate disposal of the product through countertrade quite attractive. However, although the developing country avoids having to spend the foreign exchange through the countertrade transaction, it does not obtain any foreign exchange from the world market either, as it could have eventually done otherwise. Thus engaging in countertrade will have neither a positive nor a negative effect on the country's trade balance.

Lastly, the distinction which must be made between countertrade transactions carried out from the viewpoint of a country and that of an individual firm within a developing country should be emphasised. Private enterprises are obliged to operate within the context of a given macroeconomic framework, with its corresponding set of economic policies – which may or may not be rational – and distortions. For such enterprises, recourse to a countertrade arrangement may be a logical response to overcoming certain distortions such as scarce foreign exchange allocation. However, from the point of view of a country as a whole, countertrade is not a rational economic choice, especially in a longer term perspective. Engaging in countertrade transactions is a way for governments to postpone taking action with regard to existing economic distortions. Rather than turning to rationing by quantities in a second-best situation, governments should act to correct the distortions which give rise to countertrade transactions.

When requests for countertrade are officially or unofficially backed by governments, the latter may perhaps not infringe the letter of the law as regards the international obligations to which they are committed but they may – depending on the way the countertrade procedures are set – be acting in a manner incompatible with multilateral trade principles. First, the unilateral requirements of countertrade, which are not the subject of prior negotiation, have the effect of changing the trade balance with partner countries. It is often hard to tell whether these measures are applied in a non-discriminatory manner. This is generally the case when the countertrade is imposed by an *official* regulation and is *mandatory* for certain transactions. But as we have observed, this is seldom the case. Moreover, Western exporters do not wish countertrade requirements to be implemented in a rigid manner. When countertrade is an option subject to rules that are unclear, the way in which it is applied is left to the appreciation of the bureaucracy. Any gain in flexibility may be offset by the lack of transparency surrounding the authorisation procedure, which may well conceal discriminatory practices.

ii) Long-term considerations

In the long term, countertrade transactions appear to supply less obvious benefits for developing countries, although the realisation of the disadvantages associated with this type of trade might only come after an extended period of time. If the developing countries were however to move towards carrying out their foreign trade under this form to a much greater extent than they do at present, it would be useful to ask what this might imply for both these countries and their trading partners.

Examining this possibility in terms of product categories, increased countertrade transactions in the area of *commodities* might well serve to disrupt existing trade patterns in commodity markets. Where the unloading of countertrade products rivals existing commodity agreements, this will bring downward pressure to bear on prices and push producers to non compliance with output quotas. There may also be an increased need as a result to extend financial aid to countries participating in commodity agreements or other trade agreements (e.g. Lomé) which would experience export shortfalls. The short-term benefits of lower commodity prices on world markets brought about by the increased flux of countertrade products might therefore in the long-run turn out to be disadvantageous through the destabilisation of attempts by commodity producers and consumers to smooth out highly volatile markets.

In the area of *manufactures*, market disruption through the sale of countertrade products might be less obvious. However at least two problems arise with respect to countertrade activities in this area in a longer-term context. One is the control of the marketing of these products and the other the problem of their disposal in certain situations. As manufactured products – distinct from commodities – can be differentiated, the channels and type of marketing involved to influence consumer preference (packaging, labeling, advertising) are often of crucial importance for their sale. Developing countries have traditionally been weaker and had less experience in these activities. They might therefore be pleased to hand this over in the short-run to their developed-country trading partners (trading houses or multinationals). But in the medium and long-term this would definitely be to the disadvantage of the developing countries, as they would lose control over the marketing and distribution aspect of their output and fail to develop any expertise in this area.

The other problem with countertrade and manufactures is that of disposal of these products. In the often frequent case where countertrade products are of low quality and/or outdated style, marketing skills may have their limits, and it is doubtful that even the best marketing can open up additional or even sufficient demand. Due to the difficulties in selling to consumers in developed countries, lower quality manufactured goods are often channeled toward third world markets, at eventual additional costs to consumers in the latter countries.

Up to the present, however, most of the goods offered by developing countries for countertrade transactions have been *raw materials* or *semi-processed goods*. If this continues to be the case, the problem of the development and maintenance of demand will arise in a major way, as it is doubtful that markets for these goods can be expanded above their normal level of saturation. Import demand being fairly inelastic in these cases, the sale of these goods through countertrade operations can only displace competitors, possibly by undercutting them in third markets. The medium and long-term benefits of using countertrade to expand trade in this area are thus doubtful.

A large movement towards countertrade by developing countries would introduce a substantial element of *bilateralism* into international trade, shifting it from its present predominantly multilateral framework. As all of the operational features of countertrade accentuate bilateralism, the negative aspects of countertrade as synonymous with bilateralism, can be mentioned:

i) Firstly, bilateralism in trade relations has the effect of reducing trade to the level of the country with the lowest export capacities;

ii) Secondly, insistence upon a systematic balancing of trade at the microeconomic level (i.e. for each deal or firm) will have even more pronounced limiting effects than an equilibrium set at the macroeconomic level (i.e. through a clearing system). In practice, trade policies which have insisted upon a balancing of trade either at the regional level (Yugoslavia) or the sectoral level (Indonesia) have produced results much lower than expected by the proponents.

To date, countertrade transactions by developing countries, as shown in Section III, have tended to be restricted to short-term, ad hoc deals and have not been the object of government efforts to create a longer-term structural framework around this form of trade. Even in the case of the Indonesian regulations, there is evidence that traders and authorities might not consider this to be a permanent system. This fact could be linked to the type of goods involved in such transactions (i.e. primary products for the most part) or to the perception by developing countries of the usefulness of countertrade in primarily a short-term time perspective, as a resort for overcoming severe macro economic constraints. This perception seems to be validated by the predominance of negative factors which result from the scenarios presented above. It was logical for those developing countries which have been faced with well-known macro economic problems, compounded by foreign exchange shortage, to have used western exporters to increase their access to world markets. Through countertrade operations, western firms have in certain cases become more involved in developing country products, whether this has been through an increase in joint ventures, production cooperation and/or on the marketing side. However as long as countertrade operations remain single, short-term transactions, imposed on unwilling partners, all of the disadvantages which follow from placing trade relations on a bilateral rather than a multilateral footing make countertrade the wrong solution to the long-term expansion of developing country trade.

There are several reasons to believe that constraints exist which may dampen the widespread adoption of countertrade practices by developing countries. These constraints may be summarized as follows:

i) Giving national firms the opportunity to engage in countertrade transactions raises the problem of monitoring these transactions. Not only is there an added danger of fraud, but central governments to some extent lose control over the way foreign currency earnings are used.

ii) The short-term advantages which can be drawn by developing countries through placing the *marketing* of their products with third partners will most likely be perceived in the long run to be counterproductive. Experience drawn from the Eastern European countries has shown that marketing of their products by western firms whose products and expertise are unrelated to the countertrade items in question has been rather inefficient. Moreover, numerous pitfalls are involved: cut-price sales are pushed in markets where parallel sales (often of the marketing firm's own products) are carried out; after sales service offered is poor and not readily available; finally a bad sales or product image may come to be associated with the country/product in question.

iii) *Supply constraints* on the side of the developing countries may well be a major drawback to the expansion of countertrade as these countries find difficulty in providing the type, quality and volume of product (other than commodities) that western firms would be willing to take. Supply constraints have been one of the main reasons why developing countries as a whole have not made greater advantage out of the various GSP schemes.

iv) In the long run, countertrade goods, like any others, will have to face the *protectionist barriers* that exist on certain markets. At the most it might be felt that use of the more numerous and complex channels through which countertrade goods pass could facilitate fraudulent activity with regard to rules of origin requirements. But there is no proof that this has been done on any large scale. Disguised attempts at *dumping* which countertrade may offer by allowing to propose a discounted price may appear attractive in the short run. However, though such operations may pass unnoticed as a "one-shot" sale, repeated attempts of this kind would certainly be subject to anti-dumping investigations. To date, anti-dumping actions known to the Secretariat which have been initiated with respect to countertrade goods have, however, involved East European countries only.

On the basis of the above it is clear that faced with a choice in the long run of trading in a more restricted economic environment of rigidity and heightened transactions costs or having access to the multilateral clearing system for international payments, those developing countries with convertible currencies or the possibility of returning to convertibility have an obvious advantage in maintaining or reforming an exchange rate system which allows them to facilitate trade transactions and to accumulate a universally recognised store of value whose use is not restricted.

Lastly, it must be remembered that on the whole, engaging in countertrade is a complex activity. Great expertise and a strong network of trade connections are needed to move countertrade goods efficiently and rapidly. The more complex the procedures, the higher will be the associated risks and the cost of the transaction. Developing countries lack the competence to deal with this in most cases which means that they will remain at the passive end of countertrade deals. Countertrade reproduces in many ways a Darwinian world by providing a situation without fixed points (price, market) or trading rules, which gives clout to the largest and less weight to the smallest. Developing countries will likely find themselves on the lower end of the scale in the division of costs and benefits involved in any countertrade transaction, as their negotiating power and ability to strike a favourable deal will be weaker.

V. CONCLUSIONS

The main conclusions which can be drawn at this stage of examination of countertrade operations practiced by developing countries are the following:

i) Firstly, although documentation on these operations is scarce, the information collected by the Secretariat suggests that countertrade transactions are at present a relatively marginal phenomenon in international trade. Their frequency and their geographical distribution have however increased fairly rapidly over the last five years.

ii) Developing countries' countertrade transactions almost always fall within the category of commercial compensation. They rarely take the form of large-scale transactions over a long period usually known as industrial compensation (buy-back deals). It is therefore according to the criteria applicable to commercial compensation that developing-country countertrade transactions should be judged.

iii) Developing countries often propose primary products as compensation for their imports. These products are the same as those which continue to be sold through normal commercial transactions. Countertrade operations presumably allow these countries to offer a concealed discount, either directly or indirectly, on the selling price of these products or to avoid output quota commitments.

iv) It does not seem that trade diversion due to countertrade operations has yet become very important, as the unit value of known transactions is rather small. This situation could change if developing countries which find it hard to sell primary products decided to oblige their creditors, more systematically than at present, to accept those products in payment.

v) A relationship between the degree of state participation in foreign trade and the frequency of requests for countertrade can be noted in the developing-country context. The attitude of developing countries towards countertrade is however not usually due to any wish to imitate the planned economic system and bilateral trade arrangements preferred by the Eastern countries. Above all developing countries wish for an increase in their exports which will enable them to obtain more hard currency earnings and improve their competitive position. If developing countries carry out a rather considerable number of countertrade operations with the Eastern countries, it is most likely upon the suggestion of the latter. Or else it may be for the purpose of correcting disequilibria in their balances in convertible currencies, which the developing countries feel – rightly or wrongly – to be too systematically in favour of their Eastern trading partners.

vi) Requests for countertrade addressed to OECD countries by developing countries over the past few years cannot all be explained by the same motivations. They have nevertheless certain characteristics in common. The increasing interest of this group of countries for these practices appears to coincide with the aggravation of their external disequilibria. The list of countries which are reputed to request countertrade regroups fairly well that of heavily indebted developing countries which are attempting to re-establish their external balance through a reduction of their imports and a parallel expansion of their exports. In addition, the attraction of compensation is augmented by the existence of stocks of products that are difficult to dispose of because of lack of competitivity or inelastic demand.

vii) Recent cases compiled by the Secretariat show that countertrade operations have been organized most often in response to immediate problems: liquidity crises, shrinking of export outlets for primary products, disturbance of trade patterns following the imposition of import controls. The short-term advantages of these operations motivate their choice by the countries concerned, while their drawbacks which become more evident in a longer-term context, are placed on a secondary level.

viii) Up to the present, developing countries have not attempted to integrate countertrade into their trade policy. It has not been shown that they find these practices to be a useful addition to their development policies. The vast majority of countertrade transactions catalogued by the Secretariat seem to reveal concerns linked to current economic problems. These operations would thus become superfluous when and if the countries concerned proceed to undertake needed adjustments. It is necessary to refrain however from excessive optimism; developing countries are fairly tolerant of distortions caused by their economic and commercial policies.

ix) Countertrade does not provide a viable basis for a longer-term trading strategy. Operations which seem advantageous in the short term may very well reveal themselves to be deceptive in a longer-run perspective and this for many reasons.

- Firstly, it is clear that a move to bilateralism through countertrade limits the volume of trade to the level of the partner who can do the least.
- Secondly, selecting a supplier by taking as a decisive criterion the fact that he agrees to compensation is not necessarily a rational procedure.
- Thirdly, countertrade will not bring about an increase in demand for the primary products which are mainly the object of these transactions in the North/South context: its effect would rather be that of lowering prices and compromising efforts at market regulation through commodity agreements.
- Fourthly, engaging in countertrade transactions will not allow developing countries to conserve foreign exchange unless their deliveries of countertrade goods are "additional" to normal patterns of sales, which is in any case doubtful and extremely difficult to demonstrate.
- Finally, as concerns manufactured products, countertrade will not allow developing countries to generate demand if the market appeal of their goods is unsatisfactory. Moreover, even if the initial use of the marketing services of a western trading partner appears attractive, this will not be without cost, and in the long run the relinquishing of this activity could prove to be a mistake.

x) Unwillingness or inability to finance a trade transaction in the normal fashion has to be bought at a price in one way or another. The complexity of the procedures increases both the risk of the transaction and its cost. This additional cost must finally be assumed by the partner with the weakest negotiating power. It is very doubtful that the system will allow developing countries to secure additional and long-term outlets for their products. Though one may sympathise with the developing countries' frustrations concerning market access for their exports, it is obvious that countertrade cannot bypass protectionist import barriers. Moreover, countertrade introduces rigidities and distortions into trade by inhibiting competition. It is a regressive factor in that it delays adaptation of production to changing markets.

xi) It is true that requests for countertrade do not emanate exclusively from the developing countries. Western firms suggest these procedures to countries which close their borders to their exports. This tendency may well continue as a large number of developing countries are facing problems of liquidity. Aware of their difficulties, western banks and trading companies are putting forward the opinion that countertrade is the only means of maintaining trade with these countries. They are very active in promoting these practices, with the claim that they are trying to defend the interests of their western clients.

xii) In a situation of strong competition between Western firms for the procurement of equipment contracts in developing countries, countertrade may be seen as an additional element which may sway the choice between different firms offering similar technical and financial conditions. There is therefore a danger that countertrade be made an integral part of sales to developing countries, either through a genuine desire on the part of the buyer to sell his products, or through the use of countertrade as a bargaining ploy to obtain concessions on other elements of the contract.

xiii) The inconveniences caused by countertrade requirements are disproportionate in comparison with the volume of trade involved. There is also a danger that such practices will spread, with countries and firms trying to adapt to this type of competition. Finally, it might prove difficult to revert to traditional trading practices once trade in the form of compensation has taken root and assumed a kind of respectability.

xiv) In a market economy governments are mainly responsible for defining an overall economic framework conducive to the activities of the economic actors. Private firms retain freedom of choice for their commercial decisions. If these firms believe they can make a profit through a countertrade operation and that operation does not infringe national and multilateral rules of trade, governments have no reason to prohibit acceptance of these practices.

xv) As a consequence of the lively interest currently being shown by all parties in countertrade, its advantages are often overestimated and its disadvantages minimised. Wider publicity should be given to objective analysis of the effects it may bring. Such an analysis would show that countertrade is seldom a satisfactory means of solving *lastingly* and *efficiently* the financial and trade imbalances that affect many countries.

NOTES AND REFERENCES

1. The Secretariat has compiled in an Annex the information it has collected on countertrade deals initiated during recent years by several developing countries.
2. Two Member countries only – Australia and New-Zealand – incorporate certain elements of countertrade in their trade policies with official guidelines as to how they should be applied. The United States recently made known its opposition to mandated countertrade. The American authorities consider these practices to be inefficient, a source of distortion and contrary to the open trading system. They will therefore refrain from encouraging national firms to take part in countertrade operations but will not however oppose participation if these firms believe that it is in their interest. Lastly, government to government barter may be accepted on a limited and case by case basis.
3. To date, there has been no discussion within a GATT plenary body of the compatibility of countertrade operations with articles of the General Agreement. Jurisprudence on international trade has thus far had nothing to say on the subject.
4. On the use of barter procedures by developing countries as early as 1950, see: "The Development Impact of Barter in Developing Countries", synthesis report by I. Outters-Jaeger, Development Centre, 1979.
5. It seems that countertrade operations involving petroleum increased substantially during 1984. Certain estimates put these at between 2.0 and 2.5 Mbd, athough they were below 1.0 Mbd in 1982. An important part of this barter trade in oil is carried out with the Eastern countries or among the developing countries themselves.
6. This figure might be higher if export performance requirements related to foreign investment were included.
7. A sometimes substantial proportion of trade between developing countries is unrecorded in their statistics and may possibly take the form of barter.
8. The Development Centre Study cited above tried to calculate the percentage of countertrade in the total trade of six developing countries: Egypt, Ghana, India, Nepal, Sri Lanka and Tunisia. It should be noted that these percentages range between 7 and 78 per cent according to the country and the period studied. A recent article by P.N. Agarwala in the Far Eastern Economic Review, the summary of a study for ESCAP, quotes 14 per cent of exports for Bangladesh in 1983-1984 and either 6 or 2 per cent for Indonesia between mid-1982 and end-1983, depending whether countertrade commitments or effective deliveries are taken into account (FEER, 13th August 1984).
9. See in particular the conclusions of Section III.6 in the Development Centre Study (p.102).
10. See document TD/B/AC.38/2/Add.1, dated 11th April 1984, entitled: "Developing countries and the Soviet Union: New forms of trade and economic co-operation", authored by a Soviet economist, Mr. M. Khaldine.
11. See the opinion expressed by the Trade Minister of Tanzania.
12. This could be the reason why oil-producing countries such as Iran, Libya, Nigeria and Quatar, which attempt to export beyond the quotas set by OPEC and wish to avoid unloading oil on the spot-market, are attracted by countertrade deals. It is interesting to observe that oil began surfacing in countertrade offers only after the market had shifted in favour of purchasers and prices began falling despite OPEC efforts to control supply by means of production quotas.
13. United States International Trade Commission. Analysis of recent trends in US Countertrade. Publication 1237 – March 1982. •

Annex I

THE MAIN FORMS OF COUNTERTRADE (COMPENSATION)

Commercial Compensation

Compensation in goods is required for routine export. These are generally one-shot operations, for a small or moderate amount, involving an exchange of extremely varied products which normally have no organic link between them. The transaction is completed within 36 months. The main forms of commercial compensation are:

- *Barter transactions:* direct exchange of goods without transfer of funds. This is the most primitive form of compensation. Its disadvantages, in particular for the fixing and balancing of exchange values, are such that it is at present extremely rarely used.
- *Counterpurchase:* separate contracts govern the sale of Western goods on the one hand and the exporter's commitment to buy from his partner. The type and price of counterpurchase goods are not usually specified at the stage of signing the contract but are the subject of a later one. Each of the two shipments is paid for separately, and they need not be synchronised. The commitment to buy can usually be transferred to a third party (a trading firm for example).
- *Pre-compensation:* a variant on the preceding formula. The purchase of goods from the partner country precedes the sale. These imports are paid for immediately and the amounts entered in an "evidence account" in the name of the Western firm which will subsequently obtain orders from its partner for all or part of this amount.

Industrial Compensation

These are transactions for a larger amount which usually corresponds to sales by the West of industrial equipment or turnkey factories. There is often a link between the goods traded (for example, repurchase of products manufactured by the industrial plants delivered). The delivery of the compensation products begins after receipt of the equipment and may continue for several years. These contracts generally involve complicated financial arrangements and co-operation between several Western firms. The main forms of industrial compensation are:

- *Buy-back agreements:* the supplier or suppliers of machinery or equipment undertake to import goods up to a set value of the goods delivered, either goods produced by that equipment or goods less directly related to the export. As in the case of counterpurchase, two separate contracts are signed, invoicing is in convertible currency, and third parties may participate in the sale of the buy-back products.
- *Framework agreements:* also known as long-term protocols or agreements for the exchange of goods. These agreements determine in a very general way the relationship between the partners for a period of several years. They provide for exchange of goods the nature, timing, and value of which are determined by special, renewable agreements.

Annex II

INVENTORY OF RECENT COUNTERTRADE TRANSACTIONS[1]

Algeria

Algeria is showing increasing interest in countertrade. Although these transactions have not so far been subject to any official directives stipulating the way they are to be handled, it has been noted that countertrade proposals are becoming more and more frequent and are now being made in the case of medium-sized contracts. Algeria is currently trying to diversify its exports, and a list of about 100 manufactured products selected for export promotion is being circulated to potential buyers. Countertrade offers, hitherto almost entirely confined to crude and refined oil, have been extended to textiles, plastics, metals and semi-finished metal products and farm goods (olive oil, wine and dates).

In 1981 the possibility of a barter operation with the Japanese trading house Nichimen was discussed. 500 000 barrels of Algerian oil are reported to have been traded for 16 000 Japanese cars worth an estimated £26 million. Nevertheless, Nichimen denied that this was a countertrade deal.

In recent calls for tender, national Algerian enterprises are reportedly including countertrade requests. Japanese firms appear to have been offered textiles and refined oil products in exchange for industrial plant and equipment. A United Kingdom construction company, whose contract dating from 1981 was being renegotiated, was also asked to reciprocate through countertrade.

Saudi Arabia

Wide publicity surrounded the announcement in July 1984 that Saudi Arabia had financed with oil the purchase of ten Boeing 747 aircraft (engines to be supplied by Rolls Royce) of a value of about $1 billion. It appears that in this case Saudi Arabia insisted on overseeing the marketing of such a large quantity of oil (the equivalent of one week's Saudi production) by itself selecting the agents to be made responsible for its placement on the spot market.

Bangladesh

Bangladesh has mainly engaged in countertrade with the State trading countries, offering jute, leather, tea and a few simple manufactures. The government is now trying to extend these practices to the non-traditional sectors. Buy-back offers have been made with a view to financing industrial investment.

Burma

In 1982, Burma is said to have announced that it would concentrate on trading with countries purchasing its products. It seems that various countertrade deals were made on an *ad hoc* basis. Burma can only offer traditional exports for these deals, such as rice and wood. It is reported to have bartered rice for jute sacks from Bangladesh and palm oil from Malaysia. Burma is said to be leaning towards countertrade deals based on sub-contracting.

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[1] Information collected by the Secretariat from the press and from studies on countertrade. Useful material was obtained from ACECO (Association pour la Compensation des Echanges Commerciaux, Paris) and from several delegations. All such information is subject to confirmation in view of the frequent changes in regulations in the countries concerned and the fact that it is difficult to check the details collected regarding individual transactions. The inventory has been updated in december 1984.

Brazil

Brazil is reputed often to insist on countertrade arrangements. It seems that such practices began to develop around the mid-1970s, when Brazil tried to diversify its exports geographically and turned to other developing countries which were also short of convertible currency. More recently, countertrade operations have been linked with oil supplies for Brazil and have been extended to the industrialised countries, following Brazil's efforts to increase its trade surplus, particularly through the export of manufactured products. Brazil also seems to be interested by triangular transactions which would enable it to mobilise its inconvertible creditor balances with East European countries.

As far as the Secretariat is aware, Brazil has not published any official statement laying down general rules for organising countertrade deals with its trading partners. Each individual countertrade transaction must be approved by the CACEX (Ministry of Commerce). In fact, most transactions are organised by Interbras, the trading subsidiary of the national oil company Petrobras. It would seem that various trade regulations or administrative practices might have the effect of inducing private firms to propose such deals when importing, even though the Brazilian authorities do not appear to be very keen on bringing the private sector into countertrade deals. For instance, in order to avail themselves of the tax advantages proposed by BEFIX (Commissao para concessao do Beneficos Fiscais a Programas Especiais do Exportacao), Brazilian enterprises are supposed to export goods worth three times the value of their imports. There also appears to be an export development programme under which Brazilian firms obtain import licences provided their application is accompanied by an export contract of at least the same value as the proposed imports.

Since 1982 agreements involving an exchange of Brazilian products for oil have been signed with Angola, Iran and Iraq. Similar agreements are in force with Mexico and Venezuela. Poland reportedly supplied 500 000 tonnes of oil (worth $125 million), coal and sulphur in exchange for soya oil cake, vegetable oil and a sum set against a Brazilian loan whose repayment had been blocked. Brazil has reportedly offset half its oil purchases from Mexico by supplying food and manufactured products (including equipment for petroleum exploitation). Countertrade with Iran during 1982 is said to have reached $200 million, comprising Brazilian deliveries of soya, steel and manufactured goods.

In 1983, Brazil apparently imported oil and rubber from Nigeria in exchange for manufactured goods ($4 billion according to press information). With Qatar, cement, textiles and food products were bartered for $2.5 billion worth of oil. Similar transactions (of unknown value) are said to have been concluded with China, Iraq, Malaysia and the Soviet Union.

In May 1984 the press announced that Petrobras would cease to buy oil from any country refusing to import Brazilian products. This measure would affect Abu Dhabi, Kuwait, Libya, and Qatar. In December 1984 it was announced that Volkswagen do Brasil would supply cars to Iraq in exchange for oil which would subsequently be assigned to Petrobras. The value of the contract is estimated at $630 million.

Colombia

This country is reported to have tried to offset certain imports with coffee or coal deliveries (this raises the problem of complying with the Coffee Agreement quotas). In 1982, the Soviet Union and Romania were reportedly paid in this manner for trolley-bus sales. In 1983, Colombia tried to finance the construction of a naval base by means of coffee deliveries. More recently, Colombia has tightened import restrictions and introduced an import licensing system under barter, countertrade or triangular trading arrangements. It is also said to be trying to convert positive balances blocked in East European countries.

A law passed by Parliament in December 1983 has introduced, among other measures, a "special system of trading relations" under which the government has been asked to draw up rules for barter, countertrade and triangular trading transactions. These rules have been formalized by Decree No. 370 of 15th February 1984. The legislation makes such transactions possible, after approval by INCOMEX

(Instituto Columbiano de Comercio Exterior) and subject to compliance with five criteria: durable encouragement of exports; no export possible otherwise; pricing by reference to the international market; favourable balance-of-payments impact; imports of products necessary to the country. INCOMEX is reported to have drawn up a list of 30 products (including typewriters, tractors, jeeps, computers, electronic calculators, cash registers, cameras and whisky) whose import has to be offset by deals involving the purchase of Colombian goods, exports of which must be additional to normal sales

Costa Rica

Countertrade operations are regulated by an Act of 1965 and administrative directives drawn up in 1983. They must be approved by an administrative body comprising civil servants from the Ministry of Economy and Finance and the Central Bank. This commission verifies whether the transaction is in Costa Rica's best interests and sees to it that prices are fair.

In 1983 Costa Rica reportedly offset by deliveries of coffee and onions chemicals from Israel, rice from Panama and aluminium ingots from Romania. A high proportion of Costa Rica's countertrade is with El Salvador and Nicaragua. If the information given by the Vice-Minister of Commerce on the amount of countertrade transactions approved in 1984 is correct, countertrade accounts for less than 1 per cent of Costa Rica's exports.

Dominican Republic

In May 1984 regulations for countertrade were established by Presidential Decree. A commission of the Dominican Centre for the Promotion of Exports (CEDOPEX) is responsible, jointly with the Central Bank and other government services concerned, for setting the criteria applicable to countertrade transactions and for approving and monitoring individual deals. Recently lorries and spare parts of a value of $2 million are reported to have been imported from the United States in exchange for sugar. An exchange of Dominican bauxite for Mexican buses and of cement for American lorries is said to be in course of negotiation, while construction of dockyard installations may also be financed through countertrade.

Ecuador

Little information is available. Ecuador has apparently tried in the past to market through countertrade various traditional export products such as bananas, fish, coffee, cocoa, castor oil seeds, balsa and petroleum. Bananas were reportedly traded to the Soviet Union and South Korea in 1982/83 in exchange for motor vehicles.

A countertrade deal may have been concluded sometime in the early 1980s with the United States for the equivalent of $470,000 (bananas traded for American beef cattle). Ecuador is reportedly trying to trade with other Third World countries (South Korea) on a compensation basis. In February 1984 the Central Bank fixed the exchange rate regulations applying to countertrade transactions. It would seem that these regulations are intended to discourage the offer of traditional products (petroleum, shrimps, coffee, cocoa and bananas) and to ensure that export has preceded import. All countertrade transactions must be approved by the Ministry for Industry, Commerce and Integration.

Ghana

Ghana is reported to have concluded compensation agreements with Bulgaria, for the delivery of $8 million worth of agricultural equipment, pharmaceuticals, veterinary products, leather and tyres in exchange for $5 million worth of Ghanaian cocoa, wood, rubber and industrial diamonds. The balance would be made up by a three-year loan from Bulgaria. Another deal has reportedly been concluded with the German Democratic Republic (trucks and tractors in exchange for unspecified Ghanaian products).

Indonesia

As of 1st January 1982, Indonesia introduced regulations requiring foreign firms which obtain government contracts above Rp 500 000 (approximately $500 000) to undertake purchases of

Indonesian goods other than oil in an amount equivalent to the f o b value of the goods and equipme sold to Indonesia. Proof must be given that such Indonesian export products are in addition to the usu ones. Foreign firms not meeting their compensation commitment are to be fined the equivalent of 50 pe cent of the contract value. The Indonesian authorities have issued a list of about 30 local products whic may be selected for countertrade arrangements. The list chiefly comprises primary or semi-processe products (rubber, coffee, cassava and sawn wood) and a few manufactured goods (tyres, furniture, fru juice, cigarettes, etc.). The initial regulations have subsequently been relaxed: oil has apparently bee included in at least one contract with Singapore; deadlines for completing deals have been extended a penalty rates may be reduced to 15-20 per cent if a bank guarantee is provided.

Initially, the Indonesian authorities had hoped to obtain compensation for total governmen purchases of between $2.5 and $4.5 billion per year. The amounts actually obtained have been muc smaller. Contracts signed by foreign enterprises since the new procedure was introduced probably tota less than $850 million. One of the explanations is that in May 1981 the Indonesian governmen proceeded to review 125 investment projects. Of these, 48 were cancelled, rescheduled or recast. Secondly, execution of the counterpurchase deals has been delayed by the difficulties of Indonesia producers in delivering large amounts and in proving that these are indeed additional exports. Completed exports to date account for only 20 to 30 per cent of the $850 million of govermen purchases.

The information available suggests that the programme has developed as follows. In September 1982 the Indonesian authorities announced that ten foreign firms (one each from the Federal Republic of Germany, the German Democratic Republic, Japan and Romania, three from Singapore and three from the United States) would supply fertilizers worth a total of $127 million and would purchase Indonesian products worth the equivalent. Around mid-1983, it was announced that suppliers from 14 countries had entered into countertrade commitments for a value of $543 million (including $152 million from the Federal Republic of Germany and $147 million from Japan). At around the same time, the press revealed that the United Kingdom firm Dowty had obtained a contract worth about $30 million (£20 million) for equipment intended for an Indonesian coal mine, to be offset as to 100 per cent. One of the features of this contract is that it is financed by a guaranteed buyer credi (£14.7 million) and by a grant from the Government of the United Kingdom (about £5 million).

A detailed inventory of the contracts signed under the Indonesian countertrade programme has been published by the American-Indonesian Chamber of Commerce in New York (C. Maynard "Indonesia's countertrade experience"). It lists as at January 1984 contracts for deliveries to Indonesia for an accumulated value of $765 million by 19 countries, of which eleven from the OECD area. The Federal Republic of Germany heads the list ($240 million), followed by Japan ($121 million) and the United States ($94 million); next come Romania ($62 million), Singapore ($56 million), South Korea ($53 million) and Canada ($50 million); thereafter the value of transactions falls steeply, the last seven supplier countries on the list each representing less than $2.5 million. Some sixty contracts placed by Indonesian government departments or public bodies since 1982 have thus carried commitments to purchase products supplied by Indonesia. It can be seen that these countertrade operations involve both high-value contracts (the transactions described in the previous paragraph; Romania's sale of railway cars worth $42 million. The Federal Republic of Germany's sales of locomotives for $14 million, commercial aircraft for $90 million and boats for $88 million) and many contracts with a unit value of less than $2.5 million. Countertrade deals would therefore seem to be spreading through the Indonesian public sector. Unfortunately, the inventory provides little information on the nature of the products delivered in exchange by Indonesia, their value and the delivery dates.

Iran

In 1981 and 1982, Iran faced cash problems because it was unable to sell its oil. It then introduced a countertrade policy and the press reported several major transactions. In 1982, mutton was imported from New Zealand in exchange for oil (£84 million), 30 000 tonnes of rice was imported from Uruguay and 110 000 tonnes from Thailand in exchange for oil. In 1981, Iran reportedly delivered $1.1 billion worth of oil to Romania in exchange for locomotives, tractors, oil equipment, spare parts and Romanian consultancy services.

Around mid-1982, oil exports were resumed and the Iranian authorities announced that they would abandon their barter policy. Nevertheless, an administrative regulation concerning countertrade was issued in December 1982. In 1983 particulars of a $500 million trade agreement with China, three-fifths of it on a barter basis, were reported; likewise an arrangement with Brazil for the equivalent of about $400 million and another one with Japanese trading companies whereby the earnings equivalent to half the latter's oil purchases (about $770 million over one year) would be used to buy Japanese products.

Iraq

Following payment difficulties as a result of the partial cessation of oil exports and the cost of the protracted war, Iraq reportedly offered in 1983 to settle part of its foreign debt in the form of oil shipments. These operations are said to involve Japan ($160-190 million), France (about $425 million) and South Korea. By 1983 Iraq had accumulated arrears of $390 million with about 30 Indian firms carrying out 68 projects worth a total of $2.4 billion. Following negotiations, it was apparently decided to reschedule the payment of $295 million of this amount between 1985 and 1986. The remaining $90 million was to be settled by deliveries of crude oil and sulphur to India between December 1982 and March 1983. This operation seems to have been repeated in 1984: oil and sulphur deliveries will reach $150 million whilst $600 million of payments due in 1984 will have to be rescheduled.

Israel

The Israeli government organisations are putting pressure on their foreign suppliers to buy and export domestic products in an amount equal to their sales. A barter deal was reportedly arranged in 1983 with Costa Rica, who was to deliver coffee (outside the international agreement quotas) in exchange for chemicals used for agriculture.

Jamaica

Jamaica's convertible currency earnings largely depend on its bauxite and alumina exports, which have fallen as a result of the economic recession and the island's political problems. Several recent countertrade operations organised by the state agency responsible for marketing bauxite and aluminium (BATCO) have been reported in the press. Imported goods are channelled through another state body, the Jamaican Commodity Trading Corporation. In 1982, the United States Government is said to have acquired $13.6 million worth of bauxite for strategic stocks in exchange for deliveries of powdered milk and butter oil to Jamaica. The same year, General Motors and Chrysler reportedly agreed to deliver trucks and cars in exchange for bauxite (the GM contract was to be spread over three years and to involve the delivery of 270 000 tonnes of alumina). In 1984, Jamaica was to have signed a contract with Yugoslavia: 450 000 tonnes of alumina to be exchanged over a period of five years against prefabricated houses and construction materials (value: $75 million). A seven-year contract with the Soviet Union provides for the delivery of one million tonnes of bauxite a year, in exchange for Soviet goods. Talks are reportedly being conducted with Colombia with a view to bartering alumina for coal.

Jordan

The Prime Minister is reported to have instructed all ministries and state organisations in November 1983 to give priority, when signing contracts, to firms of countries undertaking to import reasonable quantities of phosphates and potash. Several transactions are currently being considered: expansion of phosphate mines; purchase of wagons to carry the phosphates; extension of a cement works near Amman. The Jordanian National Phosphates Mining Company would be responsible for selling on the world market the ores credited to the account of foreign suppliers.

Kenya

Leading officials in Kenya have spoken in favour of barter in particular for developing intra-African trade. One operation is said to have been negotiated with the United States for the purpose of importing cereals in exchange for Kenyan coffee, tea and insecticides, but apparently it has not yet been implemented.

Libya

Libya is seeking to barter its oil, which it is finding hard to sell on Western markets. It is not known whether these proposals have materialised. A deal is reportedly being negotiated with Turkey in order to offset $700 million worth of debts to Turkey through deliveries of oil. Libya is said to have signed a ten-year agreement with the Soviet Union, involving annual oil exports worth $1 billion.

Malaysia

Malaysia began to show interest in countertrade towards the end of 1982, and several officials publicly expressed the wish that foreign suppliers buy more local products, in particular manufactured items. The policy developed so far has been one of incentives: in principle foreign suppliers are not under any obligation, but if they propose countertrade, this will be regarded as a factor in their favour when the proposal is being assessed. It was reported however that in June 1983, the Ministry of Finance instructed government bodies to include a countertrade component in their foreign purchases. As of 1st August 1983, an administrative unit was set up under the Ministry of Trade and Industry to co-ordinate countertrade proposals and decide whether they are in Malaysia's interest.

The main lines of Malaysian countertrade policy may be summarised as follows. This type of operation is welcomed with five categories of countries:

i) those whose enterprises submit tenders for major Malaysian government projects;
ii) those with which Malaysia has large trading deficits;
iii) developing countries which are major potential markets for Malaysia but where its products face strong competition;
iv) East European countries and
v) oil-producing countries.

The initiative for countertrade may come either from the foreign supplier, who may spontaneously offer to purchase such Malaysian products as he may have selected, or from a local administration which would include in the call for tender the possibility for partial financing of the deal through offsetting purchases. The percentage of compensation is not set in advance. The objective is to secure "additional" exports.

Malaysian products allowed under countertrade deals were initially limited to seven: oil, oil derivatives, tin, rubber, palm oil, timber and plywood. The list was subsequently extended to the entire Malaysian production, although now it apparently excludes natural rubber, palm oil, tin and timber.

Only three major contracts concluded under this procedure were reported in 1983. South Korea is to supply two patrol vessels to be delivered in 1985 to the Malaysian Navy. One will be built in a Malaysian shipyard using South Korean technology, the other will be supplied directly by South Korea and its price (approximately £14 million) will be offset 100 per cent by deliveries of oil, palm oil, textile, wood and electrical goods. A second deal was concluded with Yugoslavia, which is to supply circuit breakers and construct an electrical power line. Around 80 per cent of the contract (£1 million) will be paid for by deliveries of tin and rubber. A third contract of about £8 million has reportedly been signed with a Japanese firm for the supply of rails to the Malaysian Government railways.

In August 1984, Malaysia awarded a $297 million contract for the construction of a railway transit system, about $130 million of which was contracted by firms from France and Belgium. It was reported that the foreign share of the contract would be financed by a soft loan and that the suppliers would buy Malaysian goods, excluding palm oil and rubber, for the value of their deliveries.

Malaysia has also recently negotiated two separate contracts with Brazil which seem to have certain features in common. On the one hand, Malaysia will import 1.5 million tonnes of Brazilian iron ore over five years and, on the other, it will deliver 3.65 million barrels of oil to Brazil, also over five years. The value of this deal is said to exceed $100 million. In 1983 palm oil was reportedly traded with Pakistan and Thailand for rice.

Mexico

Mexican countertrade operations are directly linked to the system of exchange controls set up as of September 1982. Under a regulation issued on 4th March 1983, Mexican firms which make "additional" sales may obtain import licences and, above all, be granted a more favourable exchange rate. Exporting enterprises may conclude barter deals provided they obtain permission from the Bank of Mexico and a clearance from the Ministry of Trade and Economic Development. Their exports may then finance the goods exported to Mexico by the purchasing country. The value of the exported goods may also be used to cover ancillary expenditures related to the importation of the foreign goods. Finally, under this system unused credits may be transferred to a third party. The scale of such deals is not known.

In 1982-83, Mexico is reported to have purchased Malaysian rubber through a Malaysian trading company. This company received Mexican cocoa in payment, which it subsequently sold on the United States market.

In addition, programmes for developing the electronics and car industries were implemented by Mexico at the end of the 1970s, which contain requirements with effects similar to countertrade obligations. For instance, the 1977 decree promoting the car industry requires foreign firms constructing or assembling cars in Mexico to balance their imports and exports. In the case of electronics, foreign investments are authorised for the manufacture of certain products provided that at least 75 per cent of the output is exported or repurchased by the foreign firm.

Nicaragua

In November 1982 Nicaragua reportedly issued legislation laying down the legal framework for barter operations. The implementation of such deals is co-ordinated by the General Directorate for Economic Integration under the Ministry of Foreign Trade. A special fund has been set up by the Central Bank in order to record the operations.

Pakistan

In June 1984 Pakistan reportedly purchased six aircrafts worth $188 million from the Boeing Company. Boeing undertook to buy Pakistani products for the equivalent of 20 per cent of the amount.

Peru

Peru is among the developing countries which have had to reschedule their debt. Legislation favourable to countertrade is said to be currently under consideration, but only a very small number of operations has been concluded up to now. An agreement has reportedly been signed with the Japanese firm Marubeni for the purpose of developing a copper mine. A Japanese loan of $36 million is reported to have been provided and Marubeni to have undertaken to purchase 70 per cent of the mine's output. Similarly, a pipeline constructed by Japanese firms is said to have been financed by means of oil deliveries. Finally, Peru has reportedly offered to settle its debts with several East European countries and with Yugoslavia by delivering goods to them.

Philippines

In 1949 the Philippines introduced legislation laying down conditions for the bartering of national products that could not be sold for convertible currency on the international market, in exchange for goods considered to be essential. It does not seem however that the Philippines often utilized this legislation during the 1970s. A public body, the Philippines International Trading Corporation, was also set up to facilitate countertrade with the East European Countries and China but did not generate much business.

More recently, following the rapid deterioration in the Philippines' financial situation, there have been press reports about the renewed interest shown by the authorities in countertrade deals. At the moment, transactions of this type are apparently being negotiated with East European countries. There were also reports that a Japanese firm was financing the reopening of a copper mine in exchange for deliveries of concentrates.

In January 1984 a presidential letter of instructions authorised six countertrade deals under the National Livelihood Program, which operates under the aegis of the Ministry of Human Settlements. Purchase of food products and agro-food and light industrial equipment from Austrian, Indian, Israeli, Italian, South Korean and Swiss firms are planned under this programme. Under the presidential instructions a countertrade agency is also being set up to arrange these deals, but the Philippine products to be supplied in exchange have not been specified.

Qatar

Falling oil prices have led to payments difficulties, and since 1983 Qatar has been trying to settle its unpaid debts with oil (the Swedish firm ASEA was offered a deal of S.Kr. 175 million) and to obtain tenderers for new construction contracts willing to accept oil in partial payment.

South Korea

To the Secretariat's knowledge, South Korea does not have any official policy regarding countertrade. It seems that it has mainly concluded transactions with developing countries, either as a result of pressure from partners with which it was running a trade surplus, or on its own initiative in order to develop markets in countries with non-convertible currencies. In 1983, a unit was set up under the Ministry of Trade and Industry in order to promote countertrade operations.

Information on recent transactions is imprecise. Discussions have reportedly taken place with Argentina, the Philippines and Taiwan with a view to their trading meat (Argentina) and bananas (the Philippines and Taiwan) for South Korean manufactures. Talks are also apparently under way with Ecuador, Mexico, the Philippines and Uruguay. In 1983 the press reported a deal with Australia (beef in exchange for South Korean cotton and blended yarns) and one with Sweden (which would supply electronic and other equipment for the Pusan subway system in exchange for textile products). South Korea is said to have been bartering fertilisers for tapioca from Thailand since 1983.

Sudan

Sudan often uses countertrade practices owing to its financial difficulties, to the extreme cautiousness of foreign lenders and to chronic shortage of foreign currency. It offers agricultural products (cotton, groundnuts, maize) for countertrade deals.

Tanzania

In August 1983, the Minister of Industry took an official position in favour of countertrade, giving as example the development of Tanzanian trade with Mozambique and Bulgaria on this basis. He also expressed the opinion that this type of trade did not involve exploitation and was particularly suited to developing countries. The Minister encouraged Tanzanian firms to seek foreign partners which would accept countertrade.

Tanzania is a member of the Regional Trade Corporation, along with Madagascar, Mauritius, the Seychelles, and Zimbabwe. This regional organisation is trying to increase trade between partner countries on a non-monetary basis. Barter deals have also been organised with Cuba and the German Democratic Republic.

Tunisia

The Centre for the Promotion of Exports (CEPEX) has recently published the text of a "framework agreement on countertrade purchases". Under the terms of this agreement, the foreign exporter undertakes to submit an annual schedule for the purchase of Tunisian goods up to a certain percentage (to be negotiated) of his total sales. He may ask a third party to honour this commitment in his place, subject to the CEPEX being informed of the identity of that third party and the final destination of the goods. If the commitment to purchase is not honoured, a 10 per cent penalty, guaranteed by a banker's bond, is collected. The countertrade goods must be selected from among the following categories (certain goods being ruled out if earmarked for specified markets): agrofood; textiles; electrical and mechanical engineering products; phosphates, derived products and phosphate fertilisers.

Uruguay

A recent (1983) regulation requires all public agencies to give preference to foreign tenderers agreeing to participation of local firms or accepting compensation in the form of wool, meat, fruit or rice. It also appears to be easier to obtain an import licence if a countertrade operation is first negotiated with the Office of Foreign Trade. In 1982, $50 million worth of agricultural products were traded for Iranian oil. In 1983, Uruguay paid for $20 million worth of telecommunications equipment from Italy with exports of meat.

Venezuela

Up to now, countertrade operations have been handled by public agencies. Some operations involving the barter of oil for Brazilian sugar and Italian technical co-operation are known to have taken place. An aluminium refinery was reportedly constructed with Japanese participation, financed by deliveries of aluminium.

Yugoslavia

Yugoslavia has always sought to carry out countertrade transactions with its suppliers. Its reasons for doing so are similar to those of the East European countries, since its economic system has several features in common with theirs. Its requirements have become more urgent as a result of its deteriorating current account in 1979. Since 1977, a sequence of, at times, contradictory regulations have attempted to apportion scarce convertible currencies in line with priority needs. Hard currency receipts are shared according to a distribution key between self-managed exporting firms, republics and autonomous regions and the federal authorities. This system proved too rigid to allow an efficient functioning of the exchange market. It has thus encouraged a proliferation of "special trade agreements" (among which barter and countertrade arrangements) since they are exempted from the rule that foreign currency earned should be surrendered.

In August 1978, new foreign trade regulations provided a systematic framework for countertrade by authorising Yugoslav enterprises to obtain foreign currency for import purposes only if they could submit a countertrade contract signed by their supplier. The compensation ratio was between 40 and 100 per cent. Countertrade products had to be obtained from firms in the Republic which placed the import order. This restriction considerably limited the choice of Yugoslav products suitable for offsetting western deliveries and turned exporters away from the Yugoslav market. After obtaining the agreement of the Secretariat for Foreign Trade, Yugoslav firms were allowed to retain part of their export earnings for the purchase of essential raw materials or products unavailable in Yugoslavia. This procedure was highly successful, and many Yugoslav products previously sold directly on foreign markets were channelled into such bilateral transactions which in early 1983 accounted for almost 35 per cent of total exports and 25 per cent of imports. Subsequently, far fewer authorisations were granted. New regulations introduced in early 1984 limited compensation to 10 per cent of the value of total Yugoslav sales to any given partner country. It is not known how these regulations will be applied in practice.

In March 1984, information was circulated on the conclusion of a long-term countertrade agreement between the American firm Occidental Petroleum and two Yugoslav enterprises. Occidental is to supply oil (2 million tonnes) and coal (2 million tonnes) worth $1 billion per year for a period of ten years. No details were given on the Yugoslav products to be furnished to Occidental in exchange.

Zambia

Zambia tries to obtain countertrade deals when purchasing mining or other equipment. It has a narrow range of products to offer in exchange, copper being about the only real possibility. Barter deals with two East European countries (copper in exchange for Romanian trucks and Bulgarian foodstuffs) have proved unprofitable. Zambian authorities are said to be currently reviewing their countertrade policy: they would like to redirect it from East European countries to the industrialised ones, and to exclude copper and cobalt from the Zambian products proposed in exchange.

Zimbabwe

A unit in the Trade Ministry (Special Trading Arrangement Committee) has been given the task to organise countertrade operations. The objective is to exchange commodities produced by Zimbabwe against foreign commodities and intermediate goods. It is hoped that the Zimbabwe sales will be additional to those taking place in convertible currencies. Barter arrangements have been concluded with the German Democratic Republic (tobacco for chemicals and paper) and Romania (ferrochrome for fertilisers).

HIGH-TECHNOLOGY TRADE

WEDNESDAY, JULY 31, 1985

House of Representatives,
Subcommittee on Economic Stabilization,
Committee on Banking, Finance and Urban Affairs,
Washington, DC.

The subcommittee met, pursuant to call, at 10 a.m., in room 2220, Rayburn House Office Building, Hon. John LaFalce (chairman of the subcommittee) presiding.

Present: Chairman LaFalce; Representatives Kaptur, Levin, Wortley, and Grotberg.

Chairman **LaFalce**. The Subcommittee on Economic Stabilization will come to order.

Our country's serious trade imbalance and the deteriorating competitive position that this imbalance reflects constitutes one of the Nation's most serious economic problems. As our trade problems have become more and more evident, too many observers have sought comfort in the argument that our competitive high-technology sector will readily make up for what they deem to be the inevitable decline of our older, basic industries in international markets.

It is a facile argument and clearly not borne out by the facts. Our competitive position in high technology, like our competitive position in virtually all our basic industries, is rapidly deteriorating. Today's hearing will explore the reasons behind that deterioration and the means we might use to reverse it.

Traditionally, high-technology trade has produced substantial U.S. surpluses, even while U.S. performance was declining in other lower technology sectors. Over the past few years, however, U.S. high-technology trade surpluses have declined markedly. U.S. trade in high-technology industries slipped into a deficit position for the first time in the third quarter of last year.

The sharp drop in the 1984 high-technology trade surplus stemmed from a 44-percent jump in imports against only a 9-percent rise in exports. Communications equipment and electronic components posted a large deficit, while the traditional surplus in office computing and accounting equipment dropped sharply. The semiconductor industry's slump is worsening. Texas Instruments just posted a second quarter loss of $3.9 billion and plans to fire 1,800 workers. Our machine tool industry continues to face potentially devastating import competition concentrated at the high end of the technology scale.

Several factors such as economic growth differentials, the high dollar, growing worldwide technological and manufacturing capabilities, and differences in product quality and marketing procedures all contribute to this downward trend. While it is difficult to determine the exact role played by these factors in producing this trend, it is clear that the declining U.S. high-technology trade balance since 1981 evidences a rapid erosion in both the U.S. technological edge and in U.S. price competitiveness. As a result, the United States is losing its production base and potentially its design skills for many critical components.

While our Government sits on its hands and watches this erosion occur, our foreign competitors are moving aggressively to enhance the competitive prospects of their growth industries. High-technology imports increased significantly from almost all major suppliers, but four-fifths of the overall decline in the 1984 high-technology surplus was produced by widening high-technology trade deficits with Japan and the four East Asian newly industrializing countries—South Korea, Taiwan, Hong Kong, and Singapore.

Japan's high-technology exports are growing at an average annual rate of over 20 percent, while U.S. firms struggle unsuccessfully to get high-technology products into the Japanese market. The East Asian NIC's are aggressively pursuing export-led growth policies, which include the use of fiscal incentives to aid exporters and attract foreign investment, targeting of specific sectors for development, and tight fiscal and monetary policies designed to curb consumer goods imports and enhance the price competitiveness of exports.

An increasing number of trade disputes between the EC and the United States concerns high-technology products. EC member governments aid new technology industries in a number of ways: Direct grants of low-cost loans, liberal export credits and discriminatory State procurement policies to improve the international trade competitiveness of domestic firms, and financing research and development for the computer and telecommunications industries.

While our competitors are strategically planning the development of their high-technology sectors, we have been content to trust to luck. Our luck is running out, and the deterioration of our competitive position in key growth sectors cannot be allowed to continue.

We are pleased to have the following witnesses with us today to help us confront these important issues: Richard Heimlich, vice president for Japanese Relations at Motorola, representing the Semiconductor Industry Association; Jack McDonnell, group vice president, Electronic Industries Association; and James Mack, public affairs director of the National Machine Tool Builders' Association.

Let me welcome you. We will put the entire text of your prepared statements into the record and ask each of you to attempt to summarize your remarks in 10 minutes or so. Our first witness will be Mr. McDonnell.

STATEMENT OF JOHN J. McDONNELL, JR., GROUP VICE PRESIDENT, THE INFORMATION AND TELECOMMUNICATIONS TECHNOLOGIES GROUP OF THE ELECTRONIC INDUSTRIES ASSOCIATION

Mr. **McDonnell.** My name is Jack McDonnell. I am group vice president of the Information and Telecommunications Technologies Group of the Electronic Industries Association. I am testifying today on behalf of the ITG, which represents companies accounting for over 85 percent of U.S. production of telecommunications equipment.

In 1984, we continue to see a serious erosion in trade imbalance. Just to get the numbers into the record, in 1984, U.S. imports of telecommunications equipment were over $3.3 billion, while exports totaled $1.9 billion, giving us a negative balance of $1.4 billion—a 68-percent increase over our $0.8 billion deficit in 1983, the year our balance of trade first turned negative. In trade terms, 1984 was the worst year in our industry's history.

Now these trends would be alarming in any industry, but in the case of the telecommunications sector, we feel we still represent the world's leader in terms of technology. In fact, in spite of the high price of the dollar, which of course received more than its fair share of publicity as one of the main causes of our trade imbalance, we did——

Chairman **LaFalce.** Although the increase in the dollar vis-a-vis the yen has been the smallest increase measured against any other foreign currency, it has been only 14 to 15 percent from its low point in 1980 to its high point in 1985.

Mr. **McDonnell.** However, we did manage to increase our exports by about 6 percent in spite of the increase in the dollar. However, you cannot attribute this trade imbalance wholly or even in large part to the value of the dollar. The fact is that our trade sector has some unique problems, and our industry here in the United States has created some problems as well.

For example, overseas telecommunications equipment is purchased primarily by either Government agencies or by Government-controlled agencies, such as NTT in Japan. To a large degree, this market has been historically closed, and it is not about to be opened because this particular trade sector is not covered by the gap.

During the last round of multilateral negotiations, telecommunications equipment was eliminated from the GATT procedures. Under present conditions, we have no hope of seeing foreign markets voluntarily opened.

As a result, we have been seeking help from the Government in obtaining bilateral agreements in order to open these markets since they will not be covered by the multilateral agreements. In fact, we have been supporting legislation——

Chairman **LaFalce.** Give it to me again, why they are not covered by GATT?

Mr. **McDonnell.** In 1979, telecommunications equipment was put up as one of the trade sectors that should be covered by GATT. With the exception of Japan, every other major trading partner refused to incorporate their Government PTT's under the GATT.

Chairman LaFalce. PTT——

Mr. McDonnell. Postal Communication and Telecommunications authorities. In all of the major markets—in France, the French PTT, and all of our major trading partners—the government agency is either a direct agency of the government or the stock is owned by the government. So it is a government monopoly. They refuse to put these agencies under the jurisdiction of the GATT, thereby keeping the market closed.

Chairman LaFalce. In Japan's April 1 liberalization, did they recant on that, or do they still remain steadfast in their position to——

Mr. McDonnell. Japan supported us in 1979 and entered into a bilateral agreement whereby NTT would open their procurements——

Chairman LaFalce. I thought you said Japan didn't——

Mr. McDonnell. Japan supported us. All the others opposed us, and, therefore, it didn't pass.

Chairman LaFalce. Have we revisited that issue recently, for example, at Bonn, in discussing the GATT talks?

Mr. McDonnell. We certainly have it on the agenda. We have——

Chairman LaFalce. What is the position of the U.S. Government right now—that it should or shouldn't be included in part of the GATT talks?

Mr. McDonnell. The Government supports the position it should be in the GATT talks and the telecommunications purchases should be under GATT. That is one of the agenda items for the new round of multilateral negotiations.

Chairman LaFalce. Please continue.

Mr. McDonnell. Just to continue with the bilateral agreement with Japan. Unfortunately, it has not produced the results everybody had anticipated when we entered into the agreement. In fact, the U.S. Government in April served notice to Japan they were thinking of canceling the agreement. They gave them the 6 months' notice that was necessary, and it is entirely possible that bilateral agreement will be canceled in October.

The primary reason the Government has given is that it has not produced the results we all anticipated when we entered into that agreement. The fact is that we hope as of April 1—and we were active industry advisers in the course of the negotiations—we do hope the new scenario that has been established will present us with new market opportunities, but it is too early to tell. The best we can hope for is to see some change in 1986.

But it is now, at least on paper, much easier for U.S. companies to have their equipment certified for sale in Japan. The standards have been restricted to those that represent harm to the network, which is roughly equivalent to what we have in the United States. The certification procedures have been made much simpler.

In fact, it was interesting to note Prime Minister Nakasone's opening remarks yesterday. Basically, what he is doing is extending some of what we got to the telecommunications industry. In the case of Japan, the jury is still out.

Chairman LaFalce. What percentage of your deficit in 1984 was attributable to a deficit with Japan?

Mr. McDONNELL. I don't have the 1984 figures. But in 1983, the trade deficit was almost $1 billion.

Chairman LAFALCE. You had a trade deficit of $8 billion——

Mr. McDONNELL. We had a surplus in 1983, that is correct. The Government unfortunately—when I say the Government, I mean the executive branch of the Government, has not been responsive to our problems. We did see some legislation out of the Congress last year which we felt provided the administration with both the incentive and the means to use the open competitive market initiative and used section 301 of the Trade Act in conducting some leverage with some of our trading partners.

Unfortunately, the administration has not seen fit to use that new authority which was given to them, and, therefore, we have had to rely on the legislative initiatives that have been developed in this Congress in the hopes that somehow we can gain back the leverage that we basically unilaterally gave away by dismantling AT&T and opening up our market.

So the situation we find ourselves in today is the following: We have gone through a series of market opening procedures, finally with divestiture in 1984, which have totally opened our market to foreign products. At the same time, we are faced with closed markets overseas, and we have no leverage with which to open those markets. That is why we are supporting legislation such as what Senator Danforth has introduced in the Senate and legislation which we understand will be introduced today by Congressmen Wirth and Florio. We honestly feel that such legislation would not be necessary, if the executive branch had taken the initiative and established a trade policy, and established some bilateral negotiations using the leverage you gave to them in the 1984 Trade Act.

It seems they haven't done that, and, therefore, we continue to look to Congress for additional legislation that basically would force them to take up our cause and act on our behalf. We hope you continue to pursue these activities in the 99th Congress.

Thank you.

[The prepared statement of Mr. McDonnell, on behalf of the Information & Telecommunications Technologies Group [ITG] of the Electronic Industries Association follows:]

BEFORE THE
SUBCOMMITTEE ON ECONOMIC STABILIZATION
OF THE
COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS
U. S. HOUSE OF REPRESENTATIVES

STATEMENT OF JOHN J. McDONNELL, JR.
GROUP VICE PRESIDENT
INFORMATION & TELECOMMUNICATIONS TECHNOLOGIES GROUP
of the
ELECTRONIC INDUSTRIES ASSOCIATION

July 31, 1985

Mr. Chairman, I am John J. McDonnell, Group Vice President of the Information and Telecommunications Technologies Group (ITG) of the Electronic Industries Association. I am testifying today on behalf of the ITG, which represents companies which account for 85 percent of U.S. production of telecommunications equipment. I appreciate this opportunity to appear before your Subcommittee today.

The subject of these hearings -- the underlying causes of the erosion of our trade position in high technology -- is timely and important. I represent a major U. S. high technology industry which in the past years has seen its balance of trade turn negative -- an imbalance which is now rapidly worsening. In 1984, U.S. imports of telecommunications equipment were over $3.3 billion, while exports totaled $1.9 billion, giving us a negative balance of $1.4 billion, a 68 percent increase over our $.8 billion deficit in 1983, the year our balance of trade first turned negative. In trade terms, 1984 was the worst year in our industry's history, and there is every indication that 1985 will be significantly worse.

These trends would be alarming in any U.S. industry, but they should be a matter of particular concern in an industry such as telecommunications, where this country has always been highly competitive and the world leader in technology. Most of the major advances in telecommunications technology have occurred in U.S. laboratories, and in 1984 the U.S. International Trade Commission concluded that "U.S. firms remain foremost in telecommunications technology." The U.S. telecommunications industry has a strong record of dynamism and growth -- the number of companies in the U.S. market increased from under 380 in 1978 to 550 in 1983, and capital expenditures by this industry have been heavy and have increased significantly in recent years. In many leading-edge technologies, U.S. telecommunications products are not only superior to their foreign counterparts, but have no foreign equivalent. In short, if there were an industry in which this country should be running a large trade surplus, it is this one.

The fact that we are not is not wholly or even primarily attributable to macroeconomic factors such as the overvalued dollar. The strong dollar has certainly had some effect on our trade position. However, we have been able to hold our own in the export market despite the strongdollar -- our exports actually increased by 6 percent in 1984 over 1983 levels. The principal problem which we face is not the exchange rate or declining competitiveness, but a unique structural imbalance in market opportunities -- that is, that our own market has been thrown open to foreign sales, while the markets of our principal foreign competitors are largely closed to our products. These hearings are investigating the impact of current government policies on our high tech trade position; our industry offers a dramatic example of how a combination of U.S. and foreign government policies have undermined the U.S. trade position in high technology.

The telecommunications equipment industry is unique in the extent to which procurement decisions are affected by government policy. In most other industrialized nations, the market for telecommunications equipment is dominated by government or quasi-governmental telecommunications monopolies. With a few exceptions, such as the United Kingdom, the public telephone authorities in those nations (the "PTTs") procure almost all of their equipment from domestic suppliers. Such preferential procurement is an important element in foreign government efforts to promote the international competitive position of their telecommunications industries. In 1983 the French Minister of Posts and Telecommunications indicated that procurement by the French PTT had enabled France to establish an internationally competitive telecommunications industry and was the "linchpin" of French electronics industry development policy. 1/ Because of such policies, our potential sales are largely limited to the private sector, which in most industrialized nations only accounts for a

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1/ L'Usine Novvelle, June 16, 1983

small portion of total equipment consumption -- particularly with respect to "core" items like switching and transmission equipment, where U.S. firms are highly competitive.

The eight largest industrialized country markets represented a $21.5 billion potential market in 1983. However, despite the fact that the U.S. industry can produce equipment which is in many instances far superior to that made by indigenous suppliers in these countries, we exported less than $.5 billion in equipment to these markets in 1983, or about 2.3 percent of total consumption. We are, in effect, largely locked out of the export market in the markets of our principal competitors.

At the same time, the U.S. has progressively opened its own market to foreign sales. Although the U.S. equipment market was at one time captive to the Bell System, by the mid-1970s a series of federal court and FCC decisions had substantially opened the U.S. market to outside suppliers. The last significant barrier was removed by the AT&T divestiture, which beginning in 1984 severed the traditional relationship between Western Electric and the Bell Operating Companies. These measures were taken, unfortunately, without much consideration being given to their effect on foreign trade. While the markets of our foreign competitors remain closed to our products, by unilaterally opening our own markets, we have in effect given away the principal source of leverage which might have been used to secure improved market access for our companies abroad.

The result has been one which might have been expected. The Bell Operating Companies -- some now viewing AT&T as a competitor -- have turned to foreign equipment suppliers on a widespread scale. One former Bell company, Ameritech, has turned exclusively to foreign suppliers for PBX equipment. Imports have increased dramatically, and in some sectors, such as cellular telephones, account for a large share of total U.S. consumption. At the same time, our exports continue to confront the traditional market barriers and have increased only marginally. As a result of this imbalance in opportunities, we confront the prospect that our highly competitive industry will be substantially eroded.

The U.S. government has recognized that the structural imbalance in telecommunications trade is a serious and rapidly worsening problem. The Administration has conducted an intense series of negotiations with Japan, whose market barriers in telecommunications have proven particularly intractable. This spring these negotiations resulted in concessions by the Japanese government which substantially reduced the regulatory impediments to U.S. firms for certification of equipment for sale in the Japanese market.. Thus far, however, this progress has not been reflected in significantly increased U.S. sales. Moreover, U.S. telecommunications firms confront government-imposed market barriers in other industrialized nations which are worse than those which we now confront in Japan.

The U.S. Congress has taken an active interest in the telecommunications trade problem, and the concerns expressed by the Congress have substantially contributed to the progress which has been achieved on the negotiating front to date. The ITG has endorsed legislation introduced by Senator Danforth which would provide a comprehensive framework for a U.S. approach to the telecommunications trade problem. We have also endorsed telecommunications trade legislation jointly developed by Congressmen Florio and Wirth which we expect will be introduced shortly. We believe that these legislative initiatives squarely address the unique structural trade problem which our industry confronts, and we actively support their enactment.

We support both the Danforth and Florio-Wirth initiatives because they are designed to open foreign markets, not to close our own. Our industry has alway been a strong proponent of free trade and open markets. We welcome the competition and consumer benefits which are generated by imports and foreign investment in this market. However, without equivalent access for our own companies abroad, the long-term prospects for our industry are problematical. The Danforth and Florio-Wirth initiatives both provide for the sort of leverage which U.S. negotiators need to correct the current structural imbalance.

Finally, I might add that other U.S. and foreign government policies also have a significant effect on our trade position. For example, we have foregone substantial sales in the developing countries because we could not match various support measures which our competitors receive from their governments. These include:

- Export financing at below market interest rates to finance overseas projects;

- Subsidized and joint research and development activities;

- Linking of government aid measures (such as development aid) to developing country purchases of equipment from the nation extending the aid.

At the same time, our own government maintains policies which frustrate our efforts to expand export sales. While other countries subsidize exports with preferential financing, the U.S. government applies export controls. While other countries encourage and finance joint R&D efforts, we enforce antitrust laws which inhibit such efforts. While other countries attach strings to foreign aid grants, we consider it beneath ourselves to do so.

This country's laisse faire tradition often leads us to minimize the effect of government policies on competition. If a U.S. industry's trade position is slipping, it is often concluded that that industry has become less competitive. In telecommunications, however, we have a sector where the effect of government policies is obvious, inescapable and holds serious implications for this country's economic future. I represent a highly competitive industry that has been thrown into an artificial -- but dangerous -- negative trade position because our own market was opened without securing comparable access for our producers abroad. I commend this Subcommittee for the concern which you have shown for this problem, and I look forward to working with you in the search for constructive solutions.

Chairman LaFalce. Would you care to mention any of the points you mentioned on page 8 or 9 regarding U.S. and foreign governmental policies? You have only addressed two issues: the overvalued dollar and the structural imbalance which are caused by barriers in the foreign countries.

Mr. McDonnell. There is no question other governments have made telecommunications trade a priority, which you mentioned in your remarks. That is why I didn't pick up on them again. That is, countries like Germany and Japan make telecommunications trade a government policy. They, therefore, come through with all sorts of export financing assistance and things that we just don't have available to us through the Eximbank or any other source for financing.

This, again, is because telecommunications is viewed as a national priority in these other countries and is obviously not viewed as one in this country.

Chairman LaFalce. Have you made any attempt to quantify and document the kinds and extent of these other forms of aid in other countries?

Mr. McDonnell. Yes, we have; and, of course, those are the points we have made here, and that is there are mixed credits——

Chairman LaFalce. Could you augment your written testimony with documentation?

Mr. McDonnell. We would be happy to do that, including what interest rates are being offered?

Chairman LaFalce. Yes.

Mr. McDonnell. We would be happy to.

Chairman LaFalce. Thank you very much.

[In response to the request of Chairman LaFalce, the following information was submitted for the record by Mr. McDonnell:]

EXPORT FINANCING BY FOREIGN GOVERNMENTS FOR TELECOMMUNICATIONS EQUIPMENT

Introduction

The present document is intended as a contribution to Chairman LaFalce's Sub-Committee on Economic Stabilization of the House Committee on Banking, Finance, and Urban Affairs. It results from a promise given by John J McDonnell, Jr., Group Vice-President, Information and Telecommunications Technologies Group, Electronic Industries Association, to Chairman LaFalce during Mr McDonnell's verbal testimony before the Sub-Committee on July 31, 1985. This document is intended to augment that testimony.

The Situation in the OECD Countries to 1983

The 24 countries of the Organization of Economic Cooperation and Development (OECD) commissioned a report in 1980 on the telecommunications equipment industry in the member countries. The controversial report — entitled Telecommunications: Pressures and Policies for Change was completed in 1981, and two years later was made available to the public. It is virtually mandatory reading for anyone wishing to understand the economic infrastructure of the telecommunications industry in the world's most developed nations.

In the chapter on "The Policy Implications of Change", there is a section on measures aimed at facilitating exports. The authors focus particularly on exports from OECD to non-OECD countries. The markets involved are the major OPEC countries and a few large non-OPEC developing countries, where success depends on a relatively small number of very large contracts (e.g. Saudi Arabia in 1977, Egypt in 1979, etc). The purchasing country, in order to help finance the purchase of the equipment and to reduce the risks associated with being "locked-in" to a particular supplier, often will use international consortia bidding. This ensures a broader pool of expertise to draw on, a number of firms becoming intimately familiar with the operation of the national network, and a spreading of the benefits of the purchase over a number of supplying countries.

The authors write:

> "Given the extent of these benefits, each of the supplying countries will try to ensure the success of the consortium in which it participates. In practice, export credits and forms of "mixed credits" are frequently used to this end. The latter are generally negotiated on a state-to-state basis. Details of these negotiations are difficult to obtain, but it is clear that the sums involved are frequently large". (p.85. Emphasis added by EIA).

Information from the ExIm Bank of the U.S.A.

As this Sub-Committee is aware, the ExIm Bank of the United States is required by law to make an annual report to the Congress on export credit competition. (On the House side, the report is actually made to the parent Committee of this Sub-Committee). The most recent such report is dated September 1984 and covers the 1983 calendar year. We are informed that the report for 1984 is currently being prepared and is in draft format.

Information on specific product areas such as telecommunications is not broken out separately in the ExIm Bank report. Instead, the ExIm Bank categorizes credit into three kinds: short-term (for such immediately consumed items as agricultural fertilizers), medium-term (for smaller items of capital equipment e.g. farm machinery), and long-term (for large, capital-intensive investments such as telecommunications equipment). We would draw the attention of the Sub-Committee to the substantial amount of information in that report on long-term financing, all of which has direct bearing on the export competitiveness of the U.S. telecommunications equipment industry. For the convenience of the Sub-Committee, we reproduce below from Table 11 of the report for 1983 the ratings on official export long-term credit facilities given by U.S. exporters and bankers who were surveyed by the Ex-Im Bank:

Exporters	Bankers
Japan 1.5	France 1.0
France 1.8	Japan 1.25
Italy 2.0	Italy 1.5
U.K. 2.4	U.K. 2.0
U.S. 2.5	U.S. 2.0
Canada 2.7	Canada 2.0
Germany 3.0	Germany 2.0

1 = highly competitive
2 = basically competitive
3 = generally competitive

We would stress to the Sub-Committee that

- this represents the pre-AT&T Divestiture situation

- that it directly relates to the sales of U.S. telecom equipment in the less developed countries

- that such export financing traditionally used to sell to LDC's is now being used to sell in the post-Divestiture, completely open U.S. market and that there is a synergistic relationship between the financing and the openness of our market

Trade Distortions Due to Export Financing

Both the OECD and the ExIm Bank have pointed out the trade distortions which result from export financing. The OECD states that "competition between countries on the basis of export credits presents obvious dangers. When some supplying coutnries are willing to subsidize more heavily than others, those countries' producers may gain an advantage which is not necessarily related to their relative efficiency. In effect, this type of competition can distort the allocation of resources both between suppliers and purchasers and between suppliers. Contracts are sometimes awarded more on the basis of financial arrangements than on technology or price considerations." (pp 85-86).

Similarly, the ExIm Bank, speaking of the entire U.S. export industry, states that "several competitor countries combine development aid funds and export credits into one offer to finance the same goods and services. Buyer decisions, which would otherwise be based on price, quality, delivery date, and other commercial factors, can be distorted by an official financing offer which includes even a small amount of concessional financing." (p.33).

The latter kind of combined development aid funds and export credits are called "mixed credits". They are becoming increasingly important, especially since the OECD countries agreed in principle in October 1983 to an Arrangment on Export Credits. That Arrangement, heralded by the ExIm Bank in 1984 as "a landmark agreement", "the most significant negotiating achievement in the field of export finance in the last 10 years" sought to ensure that American exporters would be offered the lowest interest rates and the longest terms allowable under this international arrangement.

We would urge the Sub-Committee to closely monitor — through the ExIm Bank — the operation of the OECD Arrangement on Export Credits to see whether it is effective in its stated aims. We also urge the Sub-Committee to monitor — through the ExIm Bank — the loophole to that Arrangement which is provided by the "mixed credits" scenarios. In doing so, we are not unmindful that the ExIm Bank has been the object of strong public criticism, notably in the present case, from the Labor-Industry Coalition on International Trade (LICIT) whose May, 1982 report The Erosion of America's Competitive Edge: Offical Export Credits and International Competition for Jobs and Markets , we believe, still contains a great deal of validity.

On a point of detail, it should be noted that the Agency for International Development does include telecommunications in its portfolio of infrastructures. Our discussions with A.I.D. lead us to believe that the amount of concessionary financing available to U.S. exporters from this source is virtually negligible.

The Availability of Information

It is of particular concern to us in the industry that concessionary financing causing substantial distortions in international trade may be virtually hidden from public scrutiny as a result of a bi-lateral mixed-credits agreement between a supplying country and a purchasing country. A "package deal" type of approach, in which telecommunications is only one of the areas involved in the mixed credit, ensures that the statistics on the impact of export credit on the U.S. telecommunications industry are further obscured from public view. The compilation of information on such an impact becomes a large-scale research endeavor, involving a country-by-country analysis of such documentation as is in fact publicly available on lost U.S. sales and foreign concessionary financing.

Such research endeavors have been completed in regard to other U.S. industries — a recent example is the U.S. steel industry. (The Rise of Steelmaking in the Developing Countries: State Intervention in the Market and Its Effect on International Trade in Steel, prepared for Bethlehem Steel and U.S. Steel in 1984).

Direction of Future Work

We in the Information and Telecommunications Technologies Group of the Electronic Industries Association are more than willing to work with government agencies in completing a comprehensive statistical analysis of the problem. We would, however, respectfully point out that export financing is merely fuel for the flames: it is not the source of the problem.

That source lies in the fundamental structural distortion of our industry and marketplace. Our deteriorating trade balance in telecommunications equipment is directly due to the lack of reciprocal market access between the U.S. and other countries. We believe that this structural distortion must be tackled directly, rather than studying to death the problem of concessionary financing.

That is the water-torture of relevant but non-fundamental detail on which some of our most serious trade competitors are continuing to harp in an effort to cloud a correct perception of our industry's unique and uniquely serious problems.

Chairman LAFALCE. Our next witness will be Richard Heimlich, speaking on behalf of the Semiconductor Industry Association.

STATEMENT OF RICHARD W. HEIMLICH, VICE PRESIDENT FOR JAPANESE RELATIONS, MOTOROLA INC., ON BEHALF OF THE SEMICONDUCTOR INDUSTRY ASSOCIATION

Mr. HEIMLICH. Mr. Chairman, my name is Dick Heimlich. I am vice president of Japanese relations of Motorola Corp., and I appear before you today on behalf of the Semiconductor Industry Association [SIA]. SIA is an association of 52 members, which together manufacture more than 95 percent of all semiconductors produced in the United States.

The Government-imposed and condoned barriers to trade which exist in Japan have caused serious injury to U.S. companies. Because less formal governmental and private efforts to resolve the problem have proven inadequate, SIA has taken the one step open to us under U.S. law to obtain relief from these foreign government practices. On Friday, June 14, we filed a petition with the Office of the United States Trade Representative under section 301 of the Trade Act of 1974, as amended. By filing a formal 301 case, the United States and Japanese Governments' efforts can be focused on what are the essential problems in semiconductor trade, with a clear timetable for obtaining remedial action. On July 11, USTR Clayton Yeutter announced acceptance of our petition and initiation of a formal investigation.

Before I proceed with a description of the SIA case, however, I would like to stress the importance of the amendments to the 1974 Trade Act made by the Trade and Tariff Act of 1984. These amendments, particularly the addition to section 301 of language which enables the President to take action against foreign government policies which deny "fair and equitable market opportunities" to U.S. companies, played a critical role in the SIA decision to file this case.

We hope that our case, which is the first to be brought under the amended law, will prove the value of section 301 as an effective element of U.S. trade law and will demonstrate the benefits which can be gained by a periodic revision of U.S. trade laws. It will also demonstrate the benefits of periodic review of U.S. trade laws.

In our petition, we seek two things: a share of the Japanese semiconductor market which is commensurate with the United States industry's demonstrated international competitiveness, which, at a minimum, should be equal to the share Japanese semiconductor companies hold in the United States market. We also seek a commitment from the United States and Japanese Governments to take steps to forestall the dumping of semiconductors in the United States.

We in the United States have taken every possible step to achieve a greater participation in the Japanese market. We have increased the corporate resources devoted to our sales efforts in that market. We have built production, warehousing and design facilities in Japan to support our sales there (see appendix A). During periods of worldwide semiconductor shortages, we have increased the portion of our production allocated to our Japanese customers.

The U.S. Government has also been extremely helpful in working to break down Japanese barriers to semiconductor market access.

Yet, we are now faced with the reality that all of these efforts have clearly failed. We face the same problems in Japan that have existed for over a decade. Although U.S. semiconductor companies enjoy a 55-percent share of the world semiconductor market, including a majority of the European market and 46 percent of the market in the rest of the world, our share in Japan has remained at only about 10 percent.

This chart, Mr. Chairman, demonstrates the history of our participation in the Japanese market. As you can see, we call it our worm chart. Although there is not much of a wiggle to it, it is clearly below the ground. Despite increased marketing efforts, despite tariff cuts to the point of eliminating tariffs in Japan, despite the elimination of quotas and foreign investment restrictions, despite fluctuations in the exchange rate which at times have worked very much in our favor, you can see that U.S. market share has remained more or less constant throughout this period.

It also appears Japanese companies may be again using their protected home market to penetrate the U.S. market, selling their products at prices that violate the U.S. antidumping law. Micron Technologies, a small U.S. firm, has filed an antidumping complaint against Japan on 64K drams. I am sure you are aware of a recent incident involving Hitachi pricing.

At a time when the semiconductor industry worldwide is going through its most serious recession ever, with plant closings, layoffs and financial losses occurring throughout the industry in this country, these sorts of pricing practices compound the injury to U.S. semiconductor companies.

It is still clear in the Japanese market that United States companies clearly play a residual role in Japan. During the period of greatest semiconductor demand and shortest supply in early 1984, U.S. companies' sales in Japan rose far faster than the growth of the Japanese semiconductor market as a whole.

The second chart shows on a quarterly basis, the red bar being the sales of U.S. companies and the black bar being changes in the Japanese market overall.

Chairman LaFalce. The market share is declining in Japan. Is the market share declining in the United States?

Mr. Heimlich. Yes.

Chairman LaFalce. In Europe?

Mr. Heimlich. Yes.

Chairman LaFalce. Do you have charts which show the decline in market share in Europe?

Mr. Heimlich. I would be happy to provide those to you.

Chairman LaFalce. In other words, is the problem something that is simply related to Japan and their barriers, or is there a problem above and beyond that also insofar as the rest of the world is concerned? Are you going to discuss those other problems, if they exist, or are you going to focus in on Japan?

Mr. HEIMLICH. I will address some of that, and would be happy to expand on that at some point in my testimony.

Chairman LAFALCE. Fine.

Mr. HEIMLICH. As soon as the semiconductor boom began to subside, however, U.S. companies were the first companies operating in Japan to feel the effects of the slowdown. Although the Japanese market continued to grow in the fourth quarter of 1984, Japanese companies were by then able to fill all increases in domestic demand, and sales by U.S. companies actually declined.

The residual role of the U.S. companies was even more dramatically illustrated by the fact that between the fourth quarter of 1984 and the first quarter of this year, the Japanese semiconductor market softened very seriously, and U.S. companies suffered a decline in sales twice as great as the decline of the Japanese market as a whole. The efforts of our companies during the previous period of supply shortage and the agreements entered into by the Government of Japan had no effect on our role as residual suppliers.

What are the characteristics of the Japanese semiconductor market which leave foreign suppliers in this position? They are described in detail in our memorandum in support of our petition, and I have summarized them in my testimony. Rather than repeat that, I wanted to point out the problem really is a continuing problem, and sometimes the Japanese have argued that they may have done the targeting sort of approach in the past, but no longer do it.

Here is a quote from an article from Electronics Magazine, July 22, 1985. "As if that weren't enough, another challenge is on the way, the Ministry of International Trade and Industry has organized an 8-year program to develop the next generation of semiconductor production technology and is seeking $120 million for the program which could begin next spring."

Clearly, the Japanese Government is not satisfied with its success in the Japanese semiconductor industry today and continues to press ahead with these kinds of practices it has used in the past.

Chairman LAFALCE. You can't criticize them for trying to have some kind of developmental plan to improve their semiconductor industry. That is not your criticism of Japan, is it—trying to improve their production technology?

Mr. HEIMLICH. I think one has to ask the question whether in light of their success, further Government assistance is warranted at all?

Chairman LAFALCE. Well, you take a laissez-faire approach. Is it we should be criticizing Japan or we should be criticizing the United States because we are not giving similar or better assistance to our semiconductor industry?

Mr. HEIMLICH. I think both sides of that can be argued effectively.

Chairman LAFALCE. Supposing you have theological blinders on, there is nothing unfair about that, is there? There is something clearly unfair about a trade barrier, so I agree with everything you said about any trade barriers. But when you are talking about their Government giving assistance to their industry in order to improve the industry, I don't know if that violates any law or international agreement. Does it?

Mr. HEIMLICH. If such——

Chairman LaFalce. Or moral code.

Mr. Heimlich. It is not a moral issue, I agree with you. If such support injures a foreign industry, then it is a violation of international agreements. I think that it is fair to say that earlier support and subsidization by the Japanese Government of its semiconductor industry has had a serious injurious effect on our industry.

Chairman LaFalce. Is it a violation of GATT or something that can be remedied under U.S. law? There is a distinction.

Mr. Heimlich. If it is injurious, it entitles the injured party to respond.

Chairman LaFalce. But it doesn't mean——

Mr. Heimlich. It is not declared illegal, per se.

Chairman LaFalce. So it is not illegal under GATT?

Mr. Heimlich. Only if there is injury, then there is entitlement for response.

Chairman LaFalce. I wanted to clarify the fact it is not illegal.

Mr. Heimlich. In a strict sense, that is correct.

In this environment, SIA believes only a concentrated effort by the Government of Japan to eliminate those features of its market which it intentionally established to frustrate trade liberalization, will permit U.S. companies to participate in the Japanese semiconductor market to the full extent indicated by our competitiveness in other world markets.

In conjunction with those essential changes in the structure of the Japanese semiconductor market, we will seek commitments first from the Government of Japan to encourage Japanese semiconductor companies to abide by international trading rules dealing with dumping, and, second, from the United States Government to take prompt and effective action to enforce United States trade laws against actual and threatened dumping.

To put these issues into perspective, I would like to summarize for you the results of a very recent study on the impact of Japanese targeting of the United States semiconductor industry. The study was prepared by Quick and Finan Associates for the USTR as part of that agency's review of targeting under section 625 of the Trade and Tariff Act of 1984. Its conclusions have been carefully reviewed by U.S. Government agencies and by outside experts:

> Because of Japanese restrictions on direct investment, the U.S. share of the Japanese market in the 1960's and 1970's was about half of what it could have been had American firms in that period been able to establish marketing and production facilities in Japan. Once established, this market position would have probably persisted—in other words, our sales in Japan would be double their current level if investment restrictions had not existed. In 1984, that amounted to about $750 million.
>
> This suppression of U.S. sales in the Japanese market has a significant effect on learning curve benefits which in turn increases Japan's share of other markets, at U.S. expense.
>
> In the U.S. market, the estimated range for loss due to the combined effects of all Japanese targeting programs—except past restrictions on investment—ranged between * * * 18 to 49 percent—Japan's sales in the U.S. market were about $1.5 billion in 1984, so this translates into at least $270 million and as much as $750 million.

Mr. Levin. The restrictions on direct investment, that means investment by American firms in——

Mr. Heimlich. Manufacturing.

Mr. Levin. Manufacturing in Japan?

Mr. Heimlich. Right.

Mr. LEVIN. On a co-venture? What kinds of——

Mr. HEIMLICH. There was no opportunity basically to invest in a 100-percent facility. There were possibilities under a joint venture. If an American company wanted to go in there and set up a facility, it was not permitted to do that. This situation persisted until about 1975.

Just as an observation, if you add those numbers together, our trade imbalance with Japan in semiconductors would become a surplus today.

Dr. Finan's study thus finds that Japan's targeting of the semiconductor industry has had a very substantial adverse impact on United States firms. And this conclusion probably understates the problem significantly since the study did not try to estimate the indirect effects of Japanese targeting of electronic equipment industries on the U.S. semiconductor industry. If highly competitive United States electronic equipment products had not been restricted in Japan, and Japanese producers had not been supported by their government, the United States share of both Japan and the world electronic equipment market would be much greater, generating significantly larger sales opportunities for United States semiconductor firms which instead went to Japanese firms.

In conclusion, now that our petition has been filed and initiated by USTR, SIA intends to provide to the United States Government whatever support is required to open the Japanese semiconductor market to full foreign participation. We hope a negotiated solution to the issues we have raised will be reached in a timely manner. The only satisfactory long-term solution is market access, pure and simple.

We do not wish to see any restrictions imposed which would deny U.S.-consuming industries adequate volumes of semiconductors which meet their selection criteria. What we seek is to have Japan assume its full responsibilities as a trading partner with the United States. Semiconductors are an area in which U.S. producers are clearly competitive and in which we have been denied access to the Japanese market—the second largest market in the world. Only by providing United States semiconductor companies with full access to the Japanese market will Japan finally have put in place a trading environment which will reflect the competitive balance between the industries of our two nations, instead of an out-of-date model of a weak infant Japanese semiconductor industry in need of protection.

Thank you very much, Mr. Chairman, for the opportunity to testify before your committee on this subject of obvious interest to SIA and to my company.

[The prepared statement of Mr. Heimlich on behalf of the Semiconductor Industry Association follows:]

Testimony of

Richard W. Heimlich

Vice President, Motorola Inc.

on behalf of

The Semiconductor Industry Association

before the

Subcommittee on Economic Stabilization
Committee on Banking, Finance, and Urban Affairs
United States House of Representatives

July 31, 1985

Mr. Chairman, my name is Dick Heimlich. I am Vice President for Japanese Relations of Motorola Corporation, and I appear before you today on behalf of the Semiconductor Industry Association (SIA). SIA is an association of fifty-two members which together manufacture more than ninety-five percent of all semiconductors produced in the United States each year.

One of SIA's principal purposes since its foundation in 1977 has been to address issues concerning international trade in semiconductors. Foremost among these trade issues has been the restricted nature of the Japanese semiconductor market. Over the eight years since 1977, SIA has worked with the U.S. Government to seek greater access to the Japanese semiconductor market. SIA's member companies have also taken steps to make the sale of semiconductors in the Japanese market one of their top priorities. Yet, despite all of these efforts, the U.S. share of the Japanese semiconductor market remains about the same today -- at 10-11 percent -- as it was in 1975 when formal quotas prevented U.S. semiconductor companies from selling their products in Japan.

The Government-imposed and condoned barriers to trade which exist in Japan have caused serious injury to U.S. companies. Because less formal governmental and private efforts to resolve the problem have proven inadequate, SIA has taken the one step open to us under U.S. law to obtain relief from these foreign government practices. On

Friday, June 14, we filed a petition with the Office of the United States Trade Representative under Section 301 of the Trade ~~and Tariff~~ Act of 1974 as amended. By filing a formal 301 case, the U.S. and Japanese Governments' efforts can be focused on what are the essential problems in semiconductor trade, with a clear timetable for obtaining remedial action. On July 11, USTR Clayton Yeutter announced acceptance of our petition and initiation of a formal investigation.

It gives me great pleasure, Mr. Chairman, to appear before your Committee today to discuss our case. Before I proceed with a description of the SIA case, however, I would like to stress the importance of the amendments made to the Trade Act of 1974 by the Congress last year in the Trade and Tariff Act of 1984. These amendments -- particularly the addition to Section 301 of language which enables the President to take action against foreign government policies which deny "fair and equitable market opportunities" to U.S. companies -- played a critical role in the SIA decision to file this case. We hope that our case -- which is the first to be brought under the amended law -- will prove the value of Section 301 as an effective element of U.S. trade law, and will demonstrate the benefits which can be gained by a periodic revision of U.S. trade laws.

The SIA Case

In our petition, we seek two things: a share of the Japanese semiconductor market which is commensurate with the U.S. industry's demonstrated international competitiveness which, at a minimum, should be equal to the share Japanese semiconductor companies hold in the United States market. We also seek a commitment from the U.S. and Japanese Governments to take steps to forestall the dumping of semiconductors in the United States.

We in the United States have taken every possible step to achieve a greater participation in the Japanese market. We have increased the corporate resources devoted to our sales efforts in that market. We have built production, warehousing and design facilities in Japan to support our sales there (See Appendix A). During periods of worldwide semiconductor shortages, we have increased the portion of our product allocated to our Japanese customers.

The United States Government has also been extremely helpful in working to break down Japanese barriers to semiconductor market access. When the Japanese semiconductor market was protected by quotas and tariffs, the U.S. Government negotiated their elimination. When Japanese semiconductor companies began to engage in predatory pricing practices during the 1982 semiconductor recession, the U.S. Government began serious negotiations with the Government of Japan to resolve high technology trading problems through the U.S.-Japan High Technology Working Group. These negotiations resulted in the adoption by both Governments of the High Technology Agreement and the Semiconductor Recommendations which together laid the groundwork for an improved system of international trade in semiconductors between our two nations.

Yet we are now faced with the reality that all of these efforts have clearly failed. We face the same problems in Japan that have existed for over a decade. Although U.S. semiconductor companies enjoy a 55% share of the world semiconductor market including a majority of the European market and 46% of the market in the rest of the world, our share in Japan has remained at only about 10% despite our greatly increased marketing efforts, tariff cuts, the elimination of quotas, and major currency realignments.

Moreover, Japanese companies may be again using their protected home market to penetrate the U.S. market, selling their products at prices that violate the U.S. antidumping law. Micron Technologies, a small U.S. firm, has filed an antidumping complaint against Japan on 64K DRAMs. In another recent example, Hitachi has only recently ceased to utilize a pricing policy under which Hitachi distributors were instructed to sell a certain type of semiconductor product at 10 percent below the U.S. competitors' price, whatever price the competitor quotes -- with no mention at all of costs. In return, the Hitachi distributors were guaranteed a 25% profit. At a time when the semiconductor industry worldwide is going through its most serious recession ever, with plant closings, layoffs, and financial losses occurring throughout the industry in this country, these sorts of pricing practices compound the injury to U.S. semiconductor companies.

At the same time, the commitments made by the Japanese Government to eliminate trade barriers have been frustrated by government-imposed and supported "countermeasures" which have essentially substituted structural market barriers for the formal government barriers such as quotas and tariffs. SIA hopes the filing of our 301 case will permit both the United States and Japan to make the resolution of these problems a top priority international trade issue.

Through bilateral negotiations, we hope to achieve the same opportunities to sell in Japan that Japanese companies enjoy in this market (where their sales have risen from 7% of the market in 1980 to nearly 15% of the market by 1984). World trade in semiconductors is on the rise -- in all major regions of the world, that is, except Japan. We would like to eliminate those features of the Japanese semiconductor market that were intentionally established to frustrate trade liberalization and which have restricted U.S. companies to the role of residual suppliers in the Japanese semiconductor market.

U.S. companies clearly play a residual role in Japan. During the period of greatest semiconductor demand and shortest supply in early 1984, U.S. companies' sales in Japan rose far faster than the growth of the Japanese semiconductor market as a whole. This continued through the third quarter of last year. As I have described, U.S. companies were willing to divert scarce semiconductor products from other markets because they had committed themselves as part of the High Technology Working Group's Semiconductor Recommendations to support the Japanese market. Because Japanese companies were unable to supply all the product they required, Japanese purchasers of semiconductors turned to these U.S. companies during this period.

As soon as the semiconductor boom began to subside, however, U.S. companies were the first companies operating in Japan to feel the effects of the slow-down. Although the Japanese market continued to grow in the fourth quarter of 1984, Japanese companies were by then able to fill all increases in domestic demand, and sales by U.S. companies actually declined. The residual role of the U.S. companies was even more dramatically illustrated by the fact that between the fourth quarter of 1984 and the first quarter of this year the Japanese semiconductor market softened very seriously and U.S. companies suffered a decline in sales twice as great as the decline of the Japanese market as a whole. The efforts of our companies during the previous period of supply shortage and the agreements entered into by the Government of Japan had no effect on our role as residual suppliers.

What are the characteristics of the Japanese semiconductor market which leave foreign suppliers in this position? They are described in detail in our memorandum in support of our petition, but let me provide a brief overview of them.

First, the Government of Japan has protected every semiconductor end-market industry until it achieved a clear market parity with foreign producers. Because of this, Japanese companies dominate most major semiconductor end markets in Japan.

Second, the Government of Japan limited entry into the semiconductor industry to a few established end-users of semiconductors. This was accomplished through subsidies and joint research and development assistance. The result is that the same six to ten firms which are dominant in the end-use markets are also the major Japanese semiconductor manufacturers.

Third, the Japanese Government encouraged these firms to develop reciprocal interfirm trading relationships so that they would procure semiconductors primarily from each other. As a result, about two thirds of the semiconductors consumed in Japan are purchased by one of the major electronics companies from another of these major electronic companies.

Fourth, the small group of semiconductor producer-consumers are linked by multiple horizontal ties. These ties too were fostered by the Government of Japan through numerous R&D programs from which second-rank producers (and foreign companies) have been excluded. One of the purposes of these links has been to avoid the so-called "excessive" competition and duplication of effort among Japanese firms. In the United States, such horizontal ties among dominant firms would be seen as giving rise to a substantial danger of collusive and anticompetitive behavior.

Finally, the Japanese Government encouraged Japanese semiconductor purchasers to "Buy Japanese". This pressure was continued until at least 1974. Since then, U.S. semiconductor executives have been virtually unanimous in their view that a bias persists in Japan.

The entire market access situation created by these measures is perhaps best summarized by an executive in charge of one U.S. company's Japanese operations. In response to an SIA survey of U.S. companies' experiences in Japan, he said: "Basically a U.S. supplier has an opportunity when a product is not available from a Japanese source or is in short supply."

In this environment, SIA believes only concentrated effort by the Government of Japan to eliminate those features of its market which it intentionally established to frustrate trade liberalization will permit U.S. companies to participate in the Japanese semiconductor market to the full extent indicated by our competitiveness in other world markets. In conjunction with those essential changes in the structure of the Japanese semiconductor market, we will seek commitments first from the Government of Japan to encourage Japanese semiconductor companies to abide by international trading rules dealing with dumping and second from the U.S.

Government to take prompt and effective action to enforce U.S. trade laws against actual and threatened dumping.

To put these issues into perspective, I would like to summarize for you the results of a very recent study on the impact of Japanese targeting of the U.S. semiconductor industry. The study was prepared by Quick and Finan Associates for the USTR as part of that agency's review of targeting under Section 625 of the Trade and Tariff Act of 1984. Its conclusions have been carefully reviewed by U.S. Government agencies and by outside experts.

- Because of Japanese restrictions on direct investment, the U.S. share of the Japanese market in the 1960's and 1970's was about half of what it could have been had American firms in that period been able to establish marketing and production facilities in Japan. Once established, this market position would have probably persisted. (In other words, our sales in Japan would be double their current level if investment restrictions had not existed. In 1984, that amounted to about $750 million).
- This suppression of U.S. sales in the Japanese market has a significant effect on learning curve benefits which in turn increases Japan's share of other markets, at U.S. expense.
- In the U.S. market, the estimated range for loss due to the combined effects of all Japanese targeting programs (except past restrictions on investment) ranged between ... 18 to 49 percent. (Japan's sales in the U.S. market were about $1.5 billion in 1984, so this translates into at least $270 million and as much as $750 million).

Dr. Finan's study thus finds that Japan's targeting of the semiconductor industry has had a very substantial adverse impact on U.S. firms. And this conclusion probably understates the problem significantly since the study did not try to estimate the indirect effects of Japanese targeting of electronic equipment industries on the U.S. semiconductor industry. If highly competitive U.S. electronic equipment products had not been restricted in Japan, and Japanese producers had not been supported by their Government, the U.S. share of both Japan's and the world electronic equipment market would be much greater -- generating significantly larger sales opportunities for U.S. semiconductor firms which instead went to Japanese firms.

Conclusion

Now that our petition has been filed and initiated by USTR, SIA intends to provide to the U.S. Government whatever support is required to open the Japanese semiconductor market to full foreign participation. We hope a negotiated solution to the issues we have raised will be reached in a timely manner. We do not wish to reach a situation in which a resolution can only be achieved by unilateral actions of the U.S. Government such as those we have proposed in our petition. The only satisfactory long term solution is market access, pure and simple.

SIA remains committed to the principles of free and fair trade. We do not wish to see any restrictions imposed which would deny U.S. consuming industries adequate volumes of semiconductors which meet their selection criteria. What we seek is to have Japan assume its full responsibilities as a trading partner with the United States. Semiconductors are an area in which U.S. producers are clearly competitive and in which we have been denied access to the Japanese market -- the second largest market in the world. Only by providing U.S. semiconductor companies with full access to the Japanese market will Japan finally have put in place a trading environment which will reflect the competitive balance between the industries of our two nations instead of an out-of-date model of a weak infant Japanese semiconductor industry in need of protection.

Thank you very much Mr. Chairman for the opportunity to testify before your committee on this subject of obvious interest to SIA and to my company.

APPENDIX A

U.S. SEMICONDUCTOR COMPANIES HAVE MADE MAJOR EFFORTS TO ACHIEVE A GREATER SHARE OF THE JAPANESE SEMICONDUCTOR MARKET

Advanced Micro Devices --

Sales subsidiary (1974). Engineering design-in capability. Distribution through Japanese distributors. Inventory available in Japan.

American Microsystems Inc. --

Joint venture (1982). Engineering design center for semi-custom products. Direct sales and sales representatives.

Fairchild Camera and Instrument Corporation --

Subsidiary (1972). Manufacturing of semiconductors in Japan. Engineering design capability. Distribution through Japanese distributors and direct sales. Inventory available in Japan.

Harris Corporation --

Sales subsidiary (1974). KK subsidiary (1984). Test operation (1985). Distribution through Japanese distributors and direct sales force. Inventory available in Japan.

Intel Corporation --

Wholly owned subsidiary (1981). Sales, testing and design center. Corporate procurement center. Inventory available in Japan. Distribution through Japanese distributors and direct sales force.

Monolithic Memories, Inc. --

Subsidiary (1975). Testing, programming, marking and shipping conducted in Japan. Inventory available in Japan. Direct sales force and Japanese distributors.

Motorola, Inc. --

Sales subsidiary (1962). 1980 acquired 50% interest in semiconductor manufacturing company. 1982 purchased 100% of semiconductor manufacturing company. Head office Tokyo. Sales through direct sales force and eight Japanese distributors. Inventory available in Japan.

National Semiconductor Corporation --

Sales subsidiary (1973). Engineering design-in capability. Forty percent of total employees in Japan are engineers. Testing facilities for logic and linear chips. Sales through direct sales force and Japanese distributors. Inventory available in Japan.

Signetics Corporation --

Sales subsidiary (1975). Value-added center. Test floor. Application group. Sales offices in Tokyo and Osaka. Distribution by direct sales force and by Japanese distributors. Inventory available in Japan. All employees Japanese nationals or fluent in Japanese.

Texas Instruments, Inc. --

Joint venture for manufacture (1968). Wholly owned subsidiary for manufacture (1971). Two additional semiconductor manufacturing operations since 1971. Plants now located in Hatogaya, Hiji, and Miho. Distribution by direct sales force and through Japanese distributors. Inventory available in Japan.

Chairman **LaFalce**. We will not ask questions at this time. We want to hear Mr. Mack's statement. I will ask Mr. Heimlich at this time to augment your testimony. Because you have spoken almost exclusively of Japan and we have spoken of being competitive in the semiconductor industry, and yet you did say your market share was dropping in the United States and the rest of the world.

Could you give me data as to how the market share has been dropping over the past 10 years, over the past 2 years, whatever you have, for the United States and European community and the world? What percentage of semiconductor sales do sales to Japan consist of? So when you focus in on Japan and whether we are talking as a percentage of the whole, if we have had a deteriorating trade balance with the rest of the world outside of Japan, to what do you attribute that other than Japan's trade barriers?

Mr. **Heimlich**. Let me just address a couple of those questions. The share of U.S. sales that go to Japan is roughly on the order of 5 percent, while Japan represents about 30 percent of the world market. We have seen probably the greatest erosion in our position in the U.S. market as opposed to Europe and the rest of the world. In the European market, the Japanese have gained shares, a couple of points, but mainly at the expense of European companies as opposed to American companies. American companies have basically held their own, with some slight slippage in the European market.

In the rest of the world markets, a similar situation. In the U.S. market, there has been a significant erosion. To give you an order of magnitude, over the last 5 years, the Japanese share has moved from 5 percent to the order of 15 percent. That has been in terms of the erosion of our overall position in the world market. That has been the most significant factor.

I think the bottom line is we have remained reasonably competitive in the rest of the world. We have been unsuccessful in being able to participate despite intensive efforts to an increasing extent in the Japanese market. The Japanese have succeeded in substantially undermining our position in the U.S. market. They have not made as intense an effort in Europe or in some of the other markets.

Chairman **LaFalce**. I would ask you to augment that.

[The information referred to follows:]

SIA SEMICONDUCTOR INDUSTRY ASSOCIATION
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August 2, 1985

The Honorable John LaFalce
Chairman; Subcommittee on Economic Stabilization
House Banking Committee
United States House of Representatives
Washington, D.C. 20515

Dear Congressman LaFalce:

Thank you very much for the opportunity to testify before your committee on Wednesday on behalf of the Semiconductor Industry Association. In this letter I have provided additional information on the three areas you requested: U.S. companies' market share in the U.S., European and other markets outside of Japan; the size of the Japanese semiconductor market; and the percentage of U.S. companies' sales made in Japan.

TABLE 1

U.S.-BASED COMPANIES' MARKET SHARES

MARKET	1982	1983	1984
Europe	55%	56%	55%
United States	89%	86%	83%
Rest of World	47%	48%	46%
Japan	10%	11%	11%

The important point revealed by this data is that, by any measure, U.S. semiconductor companies' share of the market in Japan is artificially low. In 1982, U.S. companies' share of the European semiconductor market was 55%. In

1984, despite the very significant rise of the dollar against European currencies, U.S. companies' share in Europe remained at 55%. In the United States, U.S. companies' held 89% of the market in 1982 and 83% of the market in 1984. Yet in Japan, U.S. companies held only 10% of the market in 1982 and 11% of the market in 1984.

Moreover, as these figures indicate, U.S. companies have been able to retain a very strong position in other world markets even as their share in Japan has been limited. There is no doubt that Japanese semiconductor companies offer strong competition to U.S. companies, but it is impossible to explain the low U.S. share in Japan on those grounds given the obvious competitiveness of U.S. semiconductor products in other markets.

TABLE 2

SIZE OF THE JAPANESE SEMICONDUCTOR MARKET

	1982	1983	1984
Total consumption ($billion)	$3.98	$5.53	$8
% of World Market	28%	31%	31%

As is indicated in Table 2, the Japanese semiconductor market is growing very rapidly and has also increased in size as a percentage of the world semiconductor market. It is expected that in 1985 the Japanese market will continue to grow as a percentage of the world market. It is for this reason that U.S. companies regard the opportunity to sell their products in Japan as absolutely critical to their future growth and competitiveness.

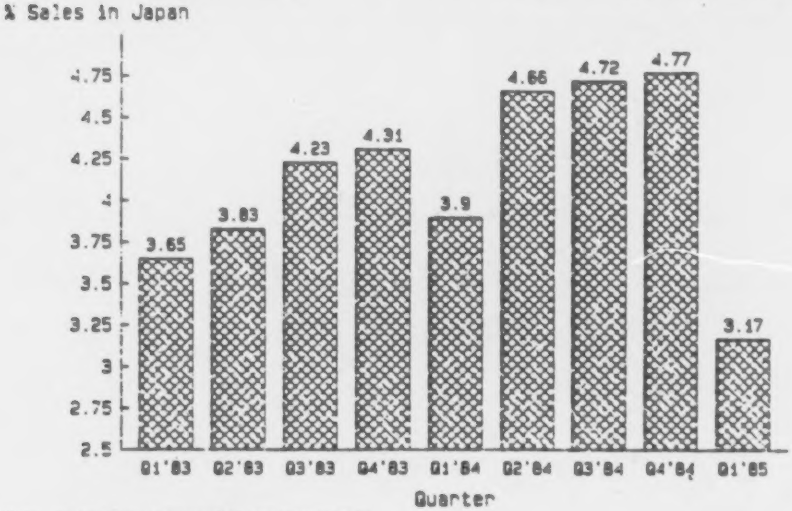
There is the danger, that if the Japanese market remains essentially closed to U.S. semiconductor companies that the U.S. semiconductor industry will become less competitive. This is because in the semiconductor industry volume production yields dramatic returns in terms of reduced unit costs. If Japanese producers have available to them all world markets and U.S. producers have only about 70% of the world market available to them, then the Japanese companies are able to obtain a very significant competitive advantage.

Graph 1 indicates the percentage of U.S. companies' sales (billings) made in the Japanese semiconductor market for each quarter from the first quarter of 1983 through the first quarter of 1985. As is clear from the graph, U.S. companies had gradually increased their allocation of product to the Japanese market from 3.65% in the

GRAPH 1

PERCENTAGE OF WORLDWIDE BILLINGS MADE IN THE JAPANESE SEMICONDUCTOR MARKET --

Weighted Avg. of 9 U.S. Companies; Preliminary



Nine companies responded representing 25% of total world semiconductor billings during 1983.

beginning of 1983 to 4.77% in the fourth quarter of 1984. However, when Japanese companies dramatically reduced their purchases of U.S. semiconductors early this year, U.S. companies were able to make only 3.17% of their total sales in Japan. U.S. companies would continue to increase the percentage of their sales in Japan if given the full opportunity to sell in that market.

I hope this additional information will be of assistance to you in your evaluation of the SIA Section 301 case. We would certainly appreciate any support you might be able to provide for our efforts to obtain full participation in the Japanese semiconductor market. Thank you again for the opportunity to testify before your Committee.

Sincerely yours,

Richard W. Heimlich

Richard W. Heimlich
Vice President, Japanese Relations
Motorola, Inc.

Chairman LaFalce. Mr. Mack.

STATEMENT OF JAMES H. MACK, PUBLIC AFFAIRS DIRECTOR, NATIONAL MACHINE TOOL BUILDERS' ASSOCIATION

Mr. Mack. Thank you, Mr. Chairman. Our purpose today is to give you a brief update on the machine tool industry competitive outlook. I will then respond to your questions.

While the economy as a whole has experienced a robust growth since the recent depression, the machine tool industry has failed to share in the cyclical expansion. The machine tool market appeared to have been gaining momentum during 1984, but from a disastrously low base in 1982 and 1983. New orders for the year were 72 percent of comparable 1983 figures, but were only 45 percent of the prior cyclical peak.

And expressed in constant dollars, the current peak in machine tool orders is below even the trough of some past recessionary periods. 1984 shipments reflecting the relatively low pace of orders in 1983 were up 23 percent over 1983 levels. Certainly the fact that the industry has begun to turn around is a hopeful sign. It appears that capital spending by our customer base seems to be increasing in 1985, and this is good news.

But a major portion of the increases in 1983 and 1984 was due to a surge in automobile manufacturing and related industries. And our auto-related orders are limited primarily to 4 of the 18 broad product lines: Transfer machines, large presses, certain grinding machines and gear-making machines. Thus while these signs are encouraging, they by no means signal a full-fledged return to prosperity for the entire machine tool industry.

Most machine tool builders continue to remain in a state of severe financial strain due to the modest recovery in shipments. And as it did in 1983, the total industry lost money in 1984, a year that at least some industry analysts now feel may have been a cyclical peak for the machine tool industry. So getting through this cash flow crisis is the industry's immediate concern, and although we are headed in the right direction, 1985 appears to be another tough year for our members.

A major complicating factor for the prospects of recovery is the specter of further import inroads into the American machine tool market. Imports measured in value accounted for 38 percent of 1984 domestic machine tool consumptions. Unfortunately, they have shown every sign of maintaining or increasing this market share as the recovery unfolds in 1985. In 1984, the total of the U.S. machine tool market grew by about 30 percent over the previous year. Domestic production grew by about 18 percent. Imports grew by 46 percent. And about one-fifth of the dollars our customer base spent on machine tools went to Japan in 1984.

The most vulnerable markets continue to be high-technology, numerically controlled [NC] turning machines and machining centers. These are two high-tech, defense-sensitive machine tools that are vital components of flexible manufacturing systems or factories of the future. They also happen to be products, which are among the most subject to export controls, because they can, under certain circumstances, make a significant contribution to the military capability of potential adversaries; 85 to 90 percent of the imports in these product lines come from Japan.

In terms of units, about 70 to 75 percent of the NC turning machine and machining center markets is taken up by imports. In terms of value, about 50 percent of the NC lathe market and about 56 percent of the machine center market were taken up by imports, and again, 85 to 90 percent of that number from Japan.

It was because of the threat of import dominance in the machine tool market that early in 1983 NMTBA filed a petition for import relief with the Secretary of Commerce under section 232 of the Trade Act of 1962, the so-called national security clause.

We have long been a proponent of free trade, and we have one of the most active international trade promotion efforts in the trade association field. We felt we could not stand idly by while key segments of the American machine tool industry were dissipated by targeted sales of foreign machine tools, and more importantly, while the national security of the United States was imperiled by the transfer of machine tool productive capacity and ultimately machine tool technology to the Far East, all of this frequently assisted by subsidies and a variety of preferential programs sponsored by foreign governments, a fact that we found blatantly inconsistent with our vital national interests.

The significance of the threat of machine tool imports goes far beyond just the welfare of the machine tool industry. If our industry is allowed to be overwhelmed by foreign products, the innovations in new manufacturing process technology that it provides American manufacturing industries will be lost and foreign firms will then have the upper hand in the development of new technology and will be leaders in the rise to be more efficient and to have lower cost production of all manufactured goods. So the loss of our machine tool building capability could well signal the beginning of the decline for all of America's metal working manufacturing industries.

The Commerce Department submitted a reportedly favorable recommendation for action to the President on February 28, 1984. Thus, for the last 17 months the fate of our industry has rested squarely in the Oval Office. Despite an overwhelming bipartisan support from the Congress, including, thank you very much, people who are represented on this panel today, the petition remains hung up in the National Security Council, and the President still hasn't acted.

With over 2 years having passed since our initial filing, most NMTBA members, aware a timely resolution is probably not forthcoming, have, out of necessity, moved ahead with investment decisions that could no longer be postponed. Some companies have decided to completely withdraw from the machine tool market; others have transferred what is left of their operations offshore.

The end result of this is an unmistakable erosion of the very core of this Nation's productive capacity. For our industry, the vigorous expansion of export markets has always been a top priority. However, since 1981, our exports have declined by 60 percent. They were about $1 billion in 1981. They went down to $400 million in 1983 and have stuck there ever since.

Our association devotes its own resources to the development and maintenance of international markets everywhere in the world. We employ three staff directors who spend virtually their full time overseas promoting U.S. machine tool exports. Our experience has shown that a vigorous export effort is critical to maintaining a competitive edge.

But these efforts have great difficulty overcoming the effects of the overvalued dollar, the lack of competitive export financing, uneven administration of what are presumably multilateral export controls under COCOM, and foreign government targeting of their machine tool exports.

And then on top of all of this, repeal of the 10-percent investment tax credit and the depletion of ACRS as proposed in the administration's tax reform package will, by increasing the cost of capital for our members and their customers, make us even less competitive at home and abroad.

So, in summary, what we have is a shrinking domestic market—a shrinking customer base, I would submit, largely because of import penetration in that customer base, exports that are stuck at levels that are 60 percent below what they were in 1981, and extraordinarily high surges in imports, about half of them from one country.

I wish I could be more positive, but the facts dictate otherwise. On the bright side, our industry is determined to survive, and survive it will. But the process of survival for many is likely to include a transfer of more productive capacity and more jobs offshore. The administration's failure to act in a timely fashion on our national security import relief petition has to a great degree produced this result, which, in our opinion, poses a dangerous threat to America's ability to mobilize against or to deter Soviet aggression.

I would be pleased to respond to your questions.

[The prepared statement of Mr. Mack on behalf of the National Machine Tool Builders' Association follows:]

STATEMENT BY
JAMES H. MACK
PUBLIC AFFAIRS DIRECTOR
NATIONAL MACHINE TOOL BUILDERS' ASSOCIATION
BEFORE THE
SUBCOMMITTEE ON ECONOMIC STABILIZATION
COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS
U.S. HOUSE OF REPRESENTATIVES
JULY 31, 1985

Good morning. My name is James Mack. I am Public Affairs Director of the National Machine Tool Builders' Association, a trade association representing just under 300 member companies which account for approximately 85 percent of machine tool production in the United States.

Our purpose today is to give you a brief update on the machine tool industry's competitive outlook.

Throughout 1983, while the economy as a whole experienced robust growth, the machine tool industry failed to share in the cyclical expansion. In fact, when measured in terms of shipments, 1983 was a disastrous year. Deliveries of new machine tools totaled just $1.8 billion, slightly more than half the level of the previous year and only about one-third the 1981 total. Although orders were up, the increase was a meager 13% over the extremely low level of 1982.

However, the machine tool market appeared to be gaining momentum during 1984. New orders for the year were 72% ahead of comparable 1983 figures -- but were only 45% of the prior cyclical peak. Shipments, reflecting the relatively slow pace of 1983 orders, were up 23% over 1983 levels. Certainly the fact that the industry has begun to turn around is a hopeful sign, as are recent surveys indicating that manufacturers plan to continue the boost in their capital spending during 1985.[1]

Certainly, this is positive news. It must be recognized, however, that to date, a major portion of the increase in 1983 and 1984 orders is due to the surge in automobile manufacturing and related industries. The machine tool industry's auto-related orders, while welcomed, are limited primarily to four product lines: transfer machines, large presses, certain grinding machines and gear-making machinery.

Thus, while these signs are encouraging, they by no means signal a full-fledged return to prosperity for the entire industry. Most machine tool builders continue to remain in a state of severe financial strain due to the modest recovery in shipments. As it did in 1983, the total industry lost money in 1984; a year some analysts now feel may be a cyclical peak. Getting through this cash-flow crisis is the industry's immediate concern. And though we are headed in the right direction, 1985 appears to be another tough year for U. S. machine tool builders.

A major factor complicating the prospects for recovery is the spectre of further import inroads into the American machine tool market. Imports, measured by value, accounted for a staggering 38% of 1984 domestic machine tool consumption. Unfortunately, imports have shown every sign of maintaining or increasing this market share as the recovery unfolds in 1985.

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[1] However, the Administration's recent proposal to eliminate accelerated capital cost recovery and the investment tax credit would, if enacted, have a disastrous impact on the rate of capital investments.

The most vulnerable domestic markets continue to be numerically controlled machining centers and turning machines -- two "high tech" and defense-sensitive machine tools which are vital components of flexible manufacturing systems and "factories of the future" that we are all hearing so much about.

It is because of the threat of import dominance in the machine tool market, the industrial backbone of American manufacturing and America's defense industries, that early in 1983 the NMTBA filed a petition for import relief with the Secretary of Commerce under Section 232 of the Trade Act of 1962, the National Security Clause. While the Association has long been a proponent of free trade and has one of the most active international trade promotion efforts in the trade association field, we cannot stand idly by while key segments of the American machine tool industry are decimated by targeted sales of foreign machine tools -- and, more importantly, while the national security of the United States is imperiled by the transfer of machine tool productive capacity to the Far East. Frequently assisted by subsidies and a variety of preferential programs sponsored by their respective governments, foreign builders have come to dominate certain key sectors of the domestic machine tool market, a fact we find blatantly inconsistent with our vital national interests.

The significance of the threat of machine tool imports goes far beyond the welfare of just the domestic machine tool building industry. If the industry is allowed to be overwhelmed by foreign products, the innovations and new manufacturing process technology that it provides America's manufacturing industries will be lost. Foreign firms will then have the upper hand in the development of new technology and will be the leaders in the drive to more efficient, lower-cost production of manufactured goods. The loss of American's machine tool building capability could well signal the beginning the the decline for all of America's metalworking manufacturing industries.

The Commerce Department submitted a reportedly favorable recommendation for action on the petition to the President on February 28, 1984. Thus, for the past 17 months, the fate of the industry's future has rested squarely in the Oval Office. Yet despite overwhelming bipartisan support from Congress for a favorable ruling, the petition remains hung up in the National Security Council and the President still has not acted.

With almost two years having passed since the initial filing, most NMTBA members, aware that a timely resolution is not forthcoming, have, out of necessity, moved ahead with investment decisions that could no longer be postponed. Some companies decided to completely withdraw from the machine tool business; others are transferring what is left of their operations offshore. The end result is, of course, an unmistakable erosion of the very core of this nation's productive capacity.

For the U. S. machine tool industry, the vigorous expansion of export markets has always been a top priority. But current levels of import penetration, the recent worldwide recession and the overvalued dollar have severely hampered the industry's ability to export on a competitive basis. Consider that in 1981, exports by U. S. machine tool makers were just over $1 billion; by 1983 exports had dropped to about $400 million -- a decline of 60 percent in two years. Both 1984 and 1985 (estimated) remain stuck at the $400 million level.

NMTBA, on behalf of the American machine tool industry, is devoting its own resources to the development and maintenance of international markets everywhere in the world. The Association employs three staff directors who spend virtually their full time overseas promoting United States machine tool exports.

NMTBA develops seminars and workshops addressing people on all aspects of international trade. We conduct market research to analyze promising markets for industry development. We have conducted numerous Industry Organized, Government Approved (IOGA) overseas promotional activities to help gain a foothold in these new markets. We sponsor foreign exhibitions so that our members will have better opportunities to display their products overseas.

In addition, we work closely with the U.S. Department of Commerce on such activities as recruiting exhibitors for export promotion events such as catalog shows, video tape shows and technical seminars. We organize reverse trade missions to bring foreign buyers to our member plants. And we bring large groups of foreign visitors to the International Machine Tool Show in Chicago every two years. In 1984, we attracted over 6,100 foreign visitors. The Commerce Department has worked closely with us in the development and implementation of these programs, as have the commercial officers in our embassies and trade centers around the world. Our experience has shown that a vigorous export promotion effort is critical to keeping and maintaining a competitive edge.

However, these efforts have great difficulty overcoming the effects of the overvalued dollar, thr lack of competitive export financing, uneven administration of presumably multilateral export controls under COCOM, and the effects of foreign government targeting of their machine tool exports. Repeal of the 10% investment tax credit and depletion of ACRS, as proposed in the Administration's tax reform package will, by increasing the cost of capital for our members and their customers, make us even less competitive at home and abroad.

I wish that I could be more positive, but the facts dictate otherwise. On the bright side, the industry is determined to survive -- and survive it will. But the process of survival for many is likely to include a transfer of more productive capacity and jobs offshore. The Administration's failure to act in a timely fashion on our national security import relief petition has produced this result -- which, in our opinion, poses a dangerous threat to America's ability to mobilize against or to deter Soviet aggression. I would be pleased to respond to your questions.

Chairman LAFALCE. Thank you very much.

I will refrain from questioning until the other members have had an opportunity to ask theirs.

Mr. Levin.

Mr. LEVIN. I find your testimony, I think, rather sobering, indeed, alarming. If you would, Mr. Mack, what is the latest you are hearing from the executive branch about the delay in action?

Mr. MACK. Well, as I understand the reason for delay, it was that it would somehow be irresponsible to make a decision with respect to this micropart of our economy until the administration had completed its review of an overall mobilization scenario. This review had been going on for some period of months, if not years, before our petition was filed, and has gone on since the finding by the Secretary of Commerce was made and forwarded to the White House 17 months ago.

Because the national security is involved, much of the information concerning this whole matter is classified. From what we are able to determine from unclassified reports, the controversy in the macro mobilization study has been resolved in the last month. OMB and the Council of Economic Advisers argued that during a mobilization, civilian demand will be substantially reduced below peacetime civilian demand. This is the mirror reverse of what happened in World War II, in the Korean conflict, and in any other mobilization that we are aware of.

Second, OMB and CEA argued that factories are somehow fungible—that quite easily and quite rapidly, you can take a factory that is making widgets and transform it into a factory that makes airplanes or guns or tanks or parts for those weapon systems. Again, this is not exactly what happened in previous mobilizations.

The driving force behind these changes in assumptions is, as we understand it, the justification of the ultimate disposal of about $11 billion of the stockpile of strategic minerals—in the same way that the Johnson and Nixon administrations did that back in the late 1960's—to try to reduce the budget deficit, which is a laudable objective.

The problem is, as you are finding in other budget deficit discussions, how you get there is important. This is not an appropriate way to get there. Having made those underlying assumptions that would justify selling of the stockpile, those same justifications—or underlying assumptions—presumably could then be used to justify turning down the machine tool petition or any other similar petition on the grounds that demand for whatever product the petition encompasses is not going to be as great as we thought it was going to be before, and therefore, we can turn down this petition.

I know that is a long response to your question, but the decision has taken a long time. It is frustrating, and, as I indicated, for many of our members the answer may well be moot in terms of decisions that they have been forced to make in the interim to locate facilities offshore.

Mr. LEVIN. Let me ask one other question, because we could have a rollcall vote. Let me just ask you quickly. Maybe one of the problems is that you are trying to fit the plummeting production in machine tools, the clause over telecommunications, over semiconductors, you are trying to fit them into niches—for example, in machine tools we are trying to say it is a dangerous threat to America's ability to deter Soviet aggression. Maybe we ought to focus on the issue whether the decline isn't a threat to America, whether it is a threat to Soviet aggression or not.

I think it gets back to the chairman's question. What happens if the Japanese open up their markets in the sense that they take down some of the barriers, et cetera?

Mr. MACK. In terms of machine tools?

Mr. LEVIN. I am asking a general question to the three of you. And what happens if they open up more of their markets, but because of practices like targeting, their manner of doing business, factors in other countries, there remains a major trade imbalance? This gets back to the chairman's question, I think, of isn't there a need for this country to take a look at our own policies, to take a look at our present pattern of essentially letting industries go down the drain? Or are you content to just say, well, that is the way the market operates?

Chairman LAFALCE. In previous testimony, our subcommittee has been advised that if Japan were to totally eliminate all its barriers, direct and indirect, we might reduce our deficit with them by almost $12 billion, which would, therefore, reduce a $150 billion projected deficit for this year to $138 billion.

Now, that is laudable, and we should attempt to achieve it, but it is not the "be all" and "end all." Therefore, we have to be aggressive in pursuing the reduction and elimination of Japan's barriers, but we also have to ask the question: What else should be done?

Mr. LEVIN. You represent three industries that are on the front burner facing extinction. You say you have survived, but it may be a quarter of the level. It could be. We need to hear from you as to your thoughts about how this country is approaching its deindustrialization.

Mr. MCDONNELL. It is interesting, because the arguments that the other countries raise in the GATT forum had to do with national security. The argument they put forward is they did not want to become reliant upon foreign suppliers for their telecommunications infrastructure because they felt that put them in a precarious position from a national security standpoint. This is the position they take as to why they do not want to bring telecommunications equipment under the GATT. They consider it to be a national security priority.

So we want to say to them that is not a valid argument, you should open up your telecommunications market the way we have ours, and that is our official position, we are trying to open up their markets, but there is some merit to their argument.

Chairman LAFALCE. Even though Japan, for your information, agrees with the United States position that it should be subject to the GATT.

Ms. Kaptur.

Ms. KAPTUR. Thank you.

First of all, for those people whose testimony I wasn't able to be here to hear, I have read it and found it extremely interesting. I appreciate you representing your industries here before our committee today.

Mr. Mack, I especially enjoyed what you had to say about defense. Who over there at the Defense Department really worries about this and the lack of—I have an article from one of the magazines about the situation back in 1941 or something, when we were in a crisis because we had no machine tool available to us in order to conduct a war—who over there has this responsibility? Who have you found?

Mr. **Mack**. In terms of our machine tool position, there were two shops at the Defense Department that——

Ms. **Kaptur**. Which ones?

Mr. **Mack**. The Industrial Base shop had a role, and the International Security Policy shop under Rich Perle's leadership had a role. It is Mr. Perle's shop that has been chiefly responsible on the export side for making sure that we don't sell any machine tools to speak of in the Soviet Union—perhaps with justification in some cases.

But he had a piece of this. Again, Ms. Kaptur, much of this is classified, so the sources of information are limited. But we are told that the Defense Department was in essential agreement with the Secretary of Commerce's recommendation to the White House on February 28. At least from our perspective the problem is not in the Defense Department. The Departments of Defense, Commerce, Energy, and Interior—the people, who have front-line responsibility for mobilization—were extraordinarily opposed to the approach that OMB and others were taking on the overall macromobilization, for obvious reasons. It is one of the reasons it took so long to resolve.

Mr. **Levin**. Let me just be clear. You are saying the Defense Department is looking after the defense of the Nation, is essentially in accord with Commerce and OMB——

Mr. **Mack**. Was essentially in accord with the Commerce Department.

Mr. **Levin**. The Defense Department.

Mr. **Mack**. Yes. On our petition.

Mr. **Levin**. Who took the opposite position?

Mr. **Mack**. I would say OMB, the Council of Economic Advisers. There were some people in the State Department early on in the process who argued that we shouldn't worry about whether or not we became foreign-source dependent because——

Ms. **Kaptur**. Which Division in the State Department argued that?

Mr. **Mack**. I will have to supply that, I will get that for you and supply the specifics for the record. Their argument was we don't need to worry about foreign-source dependency because, after all, the Soviets would be so busy trying to blow up troop ships, they wouldn't bother ships carrying equipment to make bombs.

[The information follows:]

The State Department's Office of Economic and Business Affairs was involved in processing NM-BA's 232 petition.

Ms. **Kaptur**. That information is very helpful. I wanted to ask you one thing. I have never understood, with the enormous defense buildup that has gone on in this country, why we don't have the premier machine tool industry of the world. Do I understand from your testimony that there are 85 percent of the defense-related purchases imported in that area? Is that what you are saying?

Mr. MACK. No; no; I said—in the case of machining centers and NC lathes—about 70 to 75 percent of the units—and in the case of NC lathes, about 50 percent of the value, and in the case of machining centers, 56 percent of the value—come from imports. And of that 50 or 56 percent, 85 to 90 percent come from one country—the country of Japan.

Chairman LAFALCE. Due to time constraint, I am afraid we will have to confine Ms. Kaptur to the 5-minute rule.

Mr. Grotberg.

Mr. GROTBERG. I really should not ask any questions. I will ask one of all three of you. We all know that a strong dollar is part of your problem. If you had to meet the competition, and assuming our technology is as good or better than theirs——

Mr. MACK. Today that is true. If it keeps going, it will not be true.

Mr. GROTBERG. How big a cut will you have to make in your industries to meet them in the market price if the dollar were fairly traded? If we solved the dollar value situation, how far off are we on wages worldwide in each of your industries?

Mr. HEIMLICH. In the semiconductor industry, I don't think the strong dollar has been a serious problem as it has been in some other industries. They are much more adversely affected, the computer industry and others. Wages are a relatively small portion of the total cost of production in semiconductors, and the production processes are becoming increasingly automated. So the differential in wages is not that significant a factor.

Mr. GROTBERG. You are competitive but still not getting the order, is that what you are saying?

Mr. HEIMLICH. We have not seen a significant erosion in our market position in Third World markets outside of Japan and the United States, which is where you would expect to see a significant effect.

Mr. GROTBERG. Is that true of the electronics business?

Mr. MCDONNELL. Basically, we are experiencing difficulty at the low end of our product lines. When you get down to the under $400 range, it becomes a significant factor. Unless the product is totally automated, it becomes very difficult to compete in world markets.

The most recent instance, of course, is AT&T going to Singapore to manufacture telephones and reducing the capacity of their plant in Shreveport, LA. They have never done that before. That is the first time they have gone offshore to manufacture anything. I think it is increased evidence that the electronics industry has trouble being competitive in areas that involve any degree of labor.

Mr. GROTBERG. Jim?

Mr. MACK. Congressman, I would have to get specific wage levels by country if possible and supply that for the record. Obviously, there are wage differentials between the United States and other countries. There always have been. However, despite those differentials we have always been very competitive up until a few years ago.

The problem, it seems to me, is that you do have targeting practices by some countries. You have protection of home markets by some countries. Japan, of course, doesn't spend anything on defense, so we don't need to worry about their defense industries—but the defense industries and defense departments in none of our NATO allies buys foreign equipment if it is made in that country. Our defense establishment, to some degree because of some of the publicity that has occurred, has said, "We are going to buy the lowest cost product"—and, in today's climate—the Defense Department is buying a significant number of foreign machine tools for use in U.S. Government-owned defense establishments. That is creating a problem.

As I indicated in my testimony, the uneven administration of export controls is a problem—uneven in the sense that we are very strict, as arguably we should be; and our foreign allies, presumably subject to the same regulations, let their machine tool industries or electronics industries sell darn near anything they want to the Russians or potential adversaries with very little regulation and very little policing. Another problem is the lack of competitive financing. Plus the dollar is a major problem.

I am told that the Japanese won't let the South Korean machine tool industry sell its machining centers in Japan. So market access is an important problem in Japan. Frankly, if you were to pass a law requiring market access in Japan, I am not sure it would have that much effect on U.S. shipments of machine tools to Japan.

There are some of our members who do very well in Japan because they make a type of machine tool for a particular process that the Japanese don't make, and the only place they can buy is from us. The minute they decide they can or wish to make it themselves, those members aren't going to be able to sell anything over there either.

Mr. GROTBERG. Lest the chairman think I am talking about lowering salaries—I often wonder if we shouldn't subsidize people working instead of those who aren't working?

Thank you.

Chairman LAFALCE. Mr. Wortley.

Mr. WORTLEY. Thank you, Mr. Chairman.

At the loss of comparative advantage, it will boil down to, say, four points, namely labor cost, research and development in this country, value of the dollar and unfair trade practices. What would each of you say were the key—rank those in terms of your respective industry and the effect they have had on this loss of business.

Mr. HEIMLICH. This is guess work. Off the top of my head, I would say probably I would reverse the order that you just used. In other words, I would say the trade barrier and unfair practices have been the major contributing factor to erosion of the semiconductor industry's position worldwide. The dollar has been a factor primarily in terms of affecting our customers as opposed to affecting us directly. R&D has not been a problem, and I think we have maintained a very high level of investment in R&D, while the Japanese have a higher proportion of sales in R&D and labor costs, and are frankly not a significant factor.

Mr. MCDONNELL. I don't think there is any question most markets overseas are closed is the primary one.

Chairman LAFALCE. Did you say "most markets"?

Mr. McDONNELL. Most markets are closed. Most markets in the industrialized countries are closed. Obviously, there are countries who don't have telecommunications manufacturers, and that is where we run into competition on the financing rates and the mixed credits and things like that. There are two different markets out there—the industrialized markets like Canada, France, Germany and so forth that have their own telecommunications industry, and the Third World countries that do not. We find different practices in each area that contribute to the unfair trade practices scenario.

Just one number from my testimony, the eight largest industrialized country markets represented a $21.5 billion potential market in 1983, of which we got $.5 billion, or 2.3 percent. That could only be attributed to the fact those markets are closed. We simply don't have the opportunities. I would put them in the reverse order, number one totally outclassing the other three.

Mr. MACK. R&D expenditures as a percentage of sales went up substantially in the machine tool industry during the recession. We recognize that we have to keep and increase R&D. Our industry is doing that.

Obviously the labor cost differential is significant. The dollar is extraordinarily significant. Trade barriers coupled with targeting of exports—the combination of the two is what is particularly troublesome—are a problem. And as I indicated earlier to Mr. Grotberg, I would list other factors. The cost of capital—up until 1981, there were significant differences in the cost of capital between the United States and other major trading partners. In 1981, you basically equalized that. And we are still having difficulty.

Now with this tax proposal that is before you, in our view, would go back and unequalize it against us. If you are going to unequalize the cost of capital, maybe you ought to unequalize it in our direction instead of the other direction.

Chairman LAFALCE. Thank you very much, Mr. Mack, Mr. McDonnell and Mr. Heimlich. I think the session this morning has been very educational and interesting, but regretably we have 4 minutes to catch a vote on the floor. Therefore, I am going to adjourn at this point. Thank you.

[Whereupon, at 11:20 a.m., the subcommittee was adjourned, subject to the call of the Chair.]

[The following additional material was submitted for inclusion in the record:]

STATEMENT OF THE HONORABLE NORMAN D. SHUMWAY, JULY 31, 1985

ECONOMIC STABILIZATION SUBCOMMITTEE HEARING ON THE DETERIORATING COMPETITIVE POSITION OF U.S. HIGH-TECH INDUSTRIES

The competitiveness of our high-tech industries is perhaps the most critical economic issue facing our country today. Since World War II, these industries have been the vanguard of this nation's preeminence and the much vaunted key to America's economic future. Indeed, fueled by their innovative achievements and independent spirit, the United States has moved to the cutting edge of the new technological and economic frontier of the twenty-first century.

Despite this, the high-tech industries have not been immune to the forces affecting our overall international trade position and competitiveness. Indeed, in 1984, this sector of our economy recorded a deficit with the rest of the world in trade.

This is cause for concern considering that as of 1980, the high-tech industry had amassed an enormous trade balance surplus.

What happened? What went wrong in these last five years?

There are many who would suggest that the primary cause of our decline stems from the other side of the Pacific. I am not oblivious to the present state of affairs in Japan and the other Pacific "rim" countries, whose governments have often paid lip service to our notions of free and fair trade. And I cannot ignore government sanctioned actions, such as direct subsidies, preferential financing, exclusion of U.S. products in their markets, discriminatory procurement practices and other measures that negatively affect the competitive position of our high-tech industries.

In my view, however, there are many factors that have converged to rob the industry—and our nation—of superiority in the world. First and foremost has been the cycle of ever-growing budget deficits, high interest rates and the strong dollar. The strength of the U.S. dollar and the massive U.S. budget deficit has adversely affected all sectors of our economy, including the high-tech sector.

Second, current Government policies have stifled growth and competitiveness. U.S. tax policy has penalized high-tech performance by discouraging investment both in capital assets and more importantly, research and development. Stiff U.S. export controls have penalized high-tech firms unnecessarily and put them at a distinct disadvantage vis-a-vis other foreign rivals. And current antitrust laws stifle the beneficial aspects of shared R&D efforts, joint ventures and the like.

Inroads into these areas will not solve all of the problems affecting the high-tech industry—but they will help. As for breaking down the walls of intentionally erected trade barriers, I believe we have made substantial progress, particularly with Japan. However, if existing trade laws and agreements established under the GATT are not effective, then we must go back to the table and work to strengthen them. We cannot turn our backs on these mechanisms and pursue retaliatory protectionist measures. I am convinced that the effects of this approach will be more detrimental to the high-tech industry—indeed, our entire economy—than beneficial.

Mr. Chairman, I look forward to hearing our distinguished panel of witnesses today and I am sure they will provide some very beneficial insights on these issues.

STATEMENT BY

BRUCE SMART

UNDER SECRETARY OF COMMERCE

FOR INTERNATIONAL TRADE

SUBMITTED TO THE HOUSE BANKING COMMITTEE

SUBCOMMITTEE ON ECONOMIC STABILIZATION

ON THE

COMPETITIVENESS OF U.S. HIGH TECHNOLOGY INDUSTRY

July 31, 1985

Thank you for the opportunity to testify on the competitiveness of U.S. high-technology industries. The Administration is very much concerned about our country's competitive position in high-tech products. We recognize that high-technology products are increasingly important to the American economy. The high-technology sector has contributed significantly to economic expansion, including employment and productivity growth. It has also become increasingly important to the competitiveness of other sectors. All indications are that its importance will continue to grow. The Administration is therefore determined to create a domestic and international environment that will allow our high-tech industries to compete successfully in global markets.

TRENDS AFFECTING THE COMPETITIVENESS OF U.S. HIGH-TECH INDUSTRIES

Over the past two decades, the high-technology sectors of the U.S. economy have typically enjoyed much faster growth than the more mature industrial sectors. For instance, between 1970 and 1980, high-technology industries as a group had an output growth rate of 7 percent, compared with a total industrial output growth rate of 3 percent. High technology goods --

products such as computers, semiconductors, fiber optics, telecommunications equipment, robots, lasers and pharmaceuticals -- have comprised a growing portion of U.S. manufactures exports and traditionally have been substantially larger than U.S. high-tech imports. Between 1967 and 1980, the proportion of total U.S. manufactured exports represented by high-technology goods has grown from just under 40 percent to 44 percent. The U.S. surplus in high-technology manufactures trade grew from $3.1 billion in 1965 to a peak of $26.4 billion in 1981. However, in recent years the U.S. trade surplus in high-tech products has declined significantly -- dropping to only $6.2 billion in 1984.

THE DOLLAR

The competitiveness of U.S. high-technology industries has been significantly affected by the strength of the dollar over the last 4 years. The appreciation of the dollar against the currencies of our major trading partners -- roughly 40 percent from trough to peak -- has handicapped the ability of American industry in general to compete with foreign companies both overseas and in the U.S. marketplace. While the problem may be more serious for those U.S. industries that produce standardized products competing largely on price, it has also handicapped our high-technology industries, whose products are becoming increasingly price-sensitive.

As the result of the high value of the dollar, many U.S. high-tech firms are increasing their reliance on foreign manufactured components in order to stay competitive in the U.S. and international markets. Many others are contemplating decisions to move their manufacturing operations overseas. These trends are being partially offset as many U.S. companies invest new capital to make their domestic production processes more efficient.

The Administration is taking constructive action to bring the dollar's value to a level which will allow American companies to compete. The Administration's foremost priority is to reduce the large federal budget deficit, which is contributing to the dollar's strength. We have also initiated discussions that will take place this fall with our major trading partners to discuss ways in which the international monetary system might be stabilized.

SLOW WORLD ECONOMIC GROWTH

Another significant factor contributing to the deterioration in the U.S. high-tech trade balance, and the overall trade balance as well, has been the robust economic recovery in the United States relative to the sluggish growth of our trading partners. The recent economic rebound has been the strongest in our postwar history, as U.S. real gross national product increased at an average annual rate of 5.3 percent between the end of 1982 and the end of 1984. The vitality of our domestic economy has made us a magnet for foreign imports, and the U.S. trade balance in high-technology products has suffered accordingly.

LDC DEBT BURDEN

The U.S. trade position in high-technology goods, and in general, has also suffered as the result of Less Developed Countries' efforts to restrict imports and boost exports to alleviate their enormous international debt problems. The severe cuts in LDC imports required to conserve foreign exchange for debt servicing have been a sharp blow to U.S. exports of high-tech products. The U.S. trade surplus with LDCs in high-technology manufactures declined from $10.2 billion in 1981 in just $1.9 billion in 1984.

NEW COUNTRIES

During the past two decades, the emergence of new players -- . primarily Japan, but more recently the Newly Industrializing Countries such as South Korea, Taiwan, Singapore and Brazil -- is perhaps the most significant factor contributing to the decline of the U.S. trade position in high-technology manufactures. In addition to our traditional Western European competitors, the arrival of new competitors in international markets has presented a serious challenge to American leadership in most high-tech fields.

That the United no longer commands an unchallenged lead in the high-tech industries should not necessarily surprise or alarm us. Past American predominance in advanced technology industries, as well as many traditional industries, can be attributed in large part to the extraordinary economic position of the United States after World War II. Clearly, these circumstances could not last. The new competitors that America faces in the high-tech industries today represent an inevitable change in the global environment in which U.S. firms must compete.

The major source of concern about new players in the global high-tech markets is not simply their competitive strength relative to the United States, but, more fundamentally, that their strength is bolstered by practices and policies that deny American firms the opportunity to compete on an equal footing. The basic problem is a lack of reciprocal market access. While the U.S. high-tech market remains wide open to American competitors, many foreign markets remain difficult to penetrate because of government-constructed barriers.

Japan presents perhaps the most obvious example of limiting access to its high-tech markets. Japan employs numerous barriers to high-tech trade that have kept imports to a minimum and provided Japanese firms with a large, sheltered domestic market in which to develop their high-technology capabilities.

For example, the Japanese semiconductor market was formally protected until 1975, and still remains difficult to penetrate. Problems of market access are reflected in statistics which show that U.S. companies held only 12 percent of the Japanese semiconductor market in 1984, while they had 52 percent of the world market.

The NICs have tended to follow Japan's example of restricting imports of high-technology goods while they are starting up production. Often these are products in which the United States has a competitive edge. For example, Brazil's National Informatics Law restricts U.S. informatic exports and new investment in Brazilian informatics industries. As the result, U.S. market share of informatic products in Brazil has plummeted since the restrictions first went into effect in the late 1970s.

Also cited as a major factor behind the growing competitiveness of our trading partners in the high-tech sectors is industrial targeting. The Japanese Government is considered to be the most successful at marshalling government resources and influence in order to promote its high-technology industries to the potential disadvantage of our own high-tech sectors.

However, while it is plausible to attribute some of Japan's and other countries' industrial success to their targeting efforts, it is a distortion to say that targeting is or has been the most critical factor involved. Recent sectoral studies commissioned by the Department of Commerce, the United States Trade Representative and the Department of Labor (in response to Section 625 of the Trade and Tariff Act of 1984) indicate that certain preconditions, such as a technological base from which to work, a skilled labor force, and skilled engineers, as well as a developed capital market, must exist for a targeting program to work successfully. These studies goes on to suggest that targeting practices, in sectors where they have been successful, have been critically enhanced by a protected home market.

IMPACT OF CURRENT POLICIES ON THE GROWTH POTENTIAL OF THE U.S. HIGH-TECH SECTOR

The Administration believes that improving market access for U.S. exports is one of the most essential steps toward ensuring our ability to compete in the world marketplace. This is especially true for the high-technology industries, for they must increasingly operate on a multinational level to survive and flourish.

Unfortunately, since most countries, developed and developing alike, consider the establishment of high-technology industries a matter of national economic and security policy, many governments today are under growing pressure to limit foreign access to their markets. Thus, it is more important than ever for the United States to exercise leadership in preserving and expanding free trade principles.

The Administration's efforts to secure open markets has centered thus far on Japan. Between 1965 and 1982, the proportion of imports of merchandise accounted for by high-tech products doubled for the United States and major European countries. But in the case of Japan, high-tech imports were 8 percent of total imports in 1965 -- and only 9 percent in 1982. These numbers underscore the need for much greater access to the Japanese domestic high-tech market.

As the result of the January 2, 1985 meeting between President Reagan and Prime Minister Nakasone, the United States is engaged in high-level MOSS (Market Oriented, Sector-Selective) negotiations with Japan in order to improve access to the Japanese market. In these discussions, four product sectors were initially chosen -- telecommunications, electronics, forest products, and medical equipment and pharmaceuticals. These are all sectors where there is a large market and growth potential in Japan, where the United States is competitive, and where the high visibility of market opening will set an example to other Japanese industrial sectors. As barriers are removed in these four sectors, additional sectors will be added in the future.

We have already had some success in these discussions. In the telecommunications sector, for example, the number of telecommunications services that will require prior approval and the potential burdens associated with obtaining that approval have been greatly reduced. Self-certification by U.S. firms for the compliance of their products with Japanese standards has been accepted -- the first time this concept has been accepted in Japan. Japanese standards for terminal equipment have been reduced so that they are close to those applied in the United States. Finally, representatives of Japanese subsidiaries of U.S. firms are being named to the Ministry of Posts and Telecommunication's key Advisory Council.

Despite this progress in the telecommunications area, the test of our success will be how these commitments operate in practice and whether U.S. companies are ultimately successful in selling their competitive products and services in Japan. The Administration views the MOSS negotiations as only the beginning of a process to open up the Japanese market and we will continue to press for further access.

Of course, not all our high-tech trade problems are with Japan. As I have mentioned, the NICs have shown a tendency to follow Japan's example of protecting their domestic markets while they developed their high technology industries. In addition, significant barriers to access exist in the European markets. For example, European Postal Telephone and Telegraph (PTT) monopolies favor national suppliers, and in many European countries there are unnecessarily lengthy procedures for certification and approval of telecommunications equipment. Partly as the result of these obstacles, U.S. exports of telecommunications equipment to Europe amounted to only $350 million in 1984 -- a very small percentage of the more than $20 billion European telecommunications market.

In an effort to counter these trends, the Administration has initiated high-technology discussions in numerous fora -- the GATT, the OECD and the EC directly -- to address trade distorting influences. Some of these discussions are directed at specific government actions. But we are also engaged in a larger effort to sensitize our trading partners to the advantage open competition holds for spurring the development of high-tech industries.

A high priority is the initiation of a new round of multilateral trade negotiations. The Administration views the launching of full-scale multilateral negotiations as one possible way of achieving the goals of improved trade rules for, and the lowering of tariff and non-tariff barriers on, high-technology products and services.

We recognize that it is not enough to remove foreign barriers to access. Our trade policies must be complemented by domestic policies which foster competitive high-tech industries. The Administration's record is particularly strong in this regard. For example, Federal funding for basic scientific research has increased more than 50 percent during this Administration.

Apart from this direct funding of R&D, we are also assisting firms' R&D efforts with programs designed to transfer technology from the Government to private industry. For example, the Department of Commerce's National Bureau of Standards has numerous programs that assist in the advancement of technology both in terms of research to set standards and in making available their laboratories for use by companies.

The National Aeronautics and Space Administration (NASA) has a technology utilization program which includes industrial applications centers located at universities, the purpose of which is to transfer technology from the public to the private sector. We also have major federal research programs in aeronautics, ceramics and steel-making technologies where government and industry representatives jointly discuss research agendas and share expensive, sophisticated instruments.

In addition to these efforts, we have liberalized our antitrust laws to permit U.S. companies to engage in more joint R%D. Previously, our antitrust laws discouraged companies from pooling resources for technological solutions to problems common to their industries. Given the high costs and risks of today's R&D, the allowance of cooperative R&D projects should provide a real boost to small companies with limited resources that have been the most fertile ground for technological innovation.

More generally, this Administration has implemented tax policies to stimulate investment in new plant and equipment and to increase the attraction of research and development.

Perhaps nowhere is the success of these policies as evident as it is in the extraordinary increase in the flow of funds to young high-technology companies. The available pool of venture capital, which had stagnated at about $2.5 to $3.0 billion for most of the 1970s, stood at over $11 billion in 1984.

The ultimate responsibility for the competitiveness of U.S. high-technology industries, of course, rests with the private sector. The role of the U.S. Government is to create an environment which allows American industry to capitalize on its strengths. I believe Government will fulfill this role if we continue on our present course of removing both domestic and foreign obstacles to achieving more competitive high-technology industries.

STATEMENT OF
AEROSPACE INDUSTRIES ASSOCIATION OF AMERICA, INC.
ON
HIGH TECHNOLOGY TRADE
SUBMITTED TO
SUBCOMMITTEE ON ECONOMIC STABILIZATION
COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS
U. S. HOUSE OF REPRESENTATIVES

August 13, 1985

The Aerospace Industries Association of America, Inc. (AIA) appreciates this opportunity to provide our comments for the record of the Subcommittee's July 31, 1985 hearing on high technology trade. AIA is the trade association representing the nation's major manufacturers of commercial, military and business aircraft, helicopters, aircraft engines, missiles, spacecraft and related components and equipment.

Over the last four years, the United States has posted successive record deficits in its trade balance, and it is anticipated that 1985 will continue this downward trend, with the deficit deepening to $150 billion. In contrast, during the first five years of the present decade, the adverse impact of these accumulated U. S. trade deficits was ameliorated by an aerospace total trade surplus of $59 billion. The industry's 1984 trade surplus of $10.3 billion was somewhat lower than the surpluses of previous years, but it is expected that the aerospace contribution to the 1985 overall balance of trade will be larger.

While certain protectionist policies of U. S. trading partners can be blamed in part for the ballooning American trade deficit, the truly significant factor remains the strength of the dollar, in turn a consequence of continuing high domestic deficits. Revitalization of U. S. trade performance must become a preeminent national concern. That sense of national priority will come about as the general public becomes more aware of the benefits which flow from exports, such as a strengthened domestic economy and enhanced national security and prestige.

As the leading American manufacturing exporter -- and therefore, a prime generator of the aforementioned benefits linked with a strong exporting performance -- the aerospace industry is particularly sensitive to U. S. trade policies and those of our foreign trading partners. Consequently, we are deeply concerned by the growing support within Congress for protectionist legislation as a solution to the trade deficit. Erecting barriers to foreign competition is an illusory panacea; such an approach, in the long run, will not produce an improved trade balance. Rather, resorting to protectionist actions by the U. S. will almost assuredly be met by foreign retaliatory actions which are likely to be targeted to the strongest U. S. exporting industries, such as aerospace. Ultimately, the deleterious effects of protectionist responses by the U. S. are likely to outweigh the damage attributed to the foreign trade barriers which are the targets of those responses; and the implications for the stability and health of the global trading system are equally ominous.

The aerospace industry supports the U. S. government's continuing efforts to negotiate a more equitable trading environment. In the 1950s and 1960s, the United States played an important role in developing international agreements that promoted a fair and open trading system through the multilateral reduction of tariff barriers; the success of these agreements was demonstrated by the acceleration of world trade and economic growth in the decade of the sixties. This stands in sharp contrast to the collapse of the international trading system which followed in the wake of U. S. passage of the Smoot-Hawley Act of 1930.

The U. S. aerospace industry's commitment to negotiation as the preferable route for the resolution of trade disputes is not an abstract commitment by an industry whose position in the international marketplace is relatively secure. AIA's member companies are confronted with vigorous foreign competitors, many of whom are owned or backed in varying degrees by their governments, and who have successfully combined technological capability with aggressive marketing and government support strategies. Despite this awareness of a serious future threat from government-assisted foreign competitors, the U. S. industry will continue to repudiate protectionism in favor of seeking international market discipline through multilateral trade agreements.

The Agreement on Trade in Civil Aircraft, which was developed as part of the Tokyo Round of Multilateral Trade Negotiations, provides a policy framework for free . , fair trade in the civil aircraft sector, taking into account tariff and non-tariff issues. Importantly, the Agreement provides the aircraft industry sector with an international forum for tracking developments within the industry and for settling disputes. But establishment of the Agreement, while a major step forward for trade liberalization in civil aircraft, does not guarantee that trade in this sector will be conducted on purely commercial competitive bases. Rather, the Agreement sets out standards for governments to follow in order to ease and/or eliminate distortions in the international market. The U. S. aerospace industry continues to urge ongoing action by our government to vigorously pursue compliance with and strengthening of the Aircraft Agreement and the other Codes of the General Agreement on Tariffs and Trade (GATT) which provide the foundation for enforcement of the Agreement.

Using the existing Agreement as a starting point, the U. S. aerospace industry recommends further upgrading of the current provisions in several respects:

-- expansion of duty free treatment of aircraft parts;

-- reduction, or where possible, elimination of differing technical requirements and interpretation of requirements associated with the certification of civil aircraft;

-- increased discipline with regard to those actions (directed procurements, mandatory subcontract demands or offsets, political inducements such as landing rights, etc.) governments will refrain from while major airline procurement decisions are being formulated;

-- elimination of all market distorting subsidies, whether in official government export financing, production or marketing.

Export financing is not addressed within the context of the Aircraft Agreement, however, the U. S. has sought to introduce multilateral discipline in this area through the OECD. The two operating agreements are the "Standstill Agreement on Aircraft Financing" (the Standstill) and the "Understanding on Guidelines for Officially Supported Export Credits for Large Civil Aircraft" (Large Aircraft Understanding). The former, completed in 1975, describes export financing practices applied to all aircraft, but does not set specific interest rates. The Large Aircraft Understanding was developed in 1985 between the United States and the European Community to replace the informal "Commonline", an agreement reached by the U. S., Great Britain, France and West Germany. The Large Aircraft Understanding improved on the minimum interest rates and terms set by the Commonline in that it:

-- ties the minimum interest rate to market rates in both dollar and European denominated currencies;

-- includes a 12-year option in addition to the 10-year maximum term of the Commonline;

-- prohibits tied aid or mixed credits;

-- addresses financing in producer-country markets.

Again, this particular agreement also establishes an official framework for negotiating improvements. In particular, the U. S. government is seeking loan terms that realistically reflect the useful life of most aircraft -- 15 to 20 years in the case of commercial jet transports -- and which reach true market interest rates. Another critically important negotiating goal for the United States is to expand export financing discipline to all present and future large aircraft models, helicopters, general aviation aircraft, and used aircraft, as well as to aircraft leasing practices.

While export subsidies remain a troublesome aspect of the world market, they are a problem far more visible and thus more easily addressed than government subsidies supporting foreign aircraft development and manufacture. Both the Aircraft Agreement and the GATT Subsidy Code address the issue of such government assistance, but documenting the existence and level of subsidy in order to prove injury through the established GATT dispute mechanisms has been difficult. Industry has consequently stressed the upgrading of the U. S. government's fact-finding and analysis in this respect, in order to facilitate the enforcement of the relevant multilateral agreement provisions.

Importantly, and perhaps paramount among the critically needed improvements, the U. S. should seek the participation of other aircraft producing nations who are not currently signatories to the relevant agreements covering trade in civil aircraft -- in particular, Brazil, Indonesia and Israel.

While the GATT and its Codes, including the Aircraft Agreement, are crucial to the long-term viability of the international trading system, industry also believes that the U. S. government -- while continuing to seek adjustments in these agreements -- should also take certain interim, defensive actions to counteract foreign government market distorting practices. Such actions would involve political and diplomatic pressure to match, and thus neutralize, those practices. Such actions obviously should be tailored to the specific situation. It is important to stress that what industry is recommending is reciprocity -- that any U. S. actions taken be specifically targeted to the offending country, and to the product category which is the focus of the dispute.

Finally, AIA and its member companies believe that the United States, if it is to remain a vigorous contender in international trade, must adopt a unified and coordinated program which embraces a national commitment to the two key factors affecting the marketplace: stable trade and R&D policies. This recommendation is set out in the AIA publication, "Trade and R&D Policies: An Aerospace Industries Association Proposal", copies of which accompany this statement.

We recognize that a policy of adhering to internationally established trade rules and procedures for resolving disputes does not offer the "quick fix" which many are currently seeking, but our industry is convinced that any U. S. resort to protectionist actions or policies will invite retaliation by foreign governments against those U. S. manufacturing sectors that still reflect a trade surplus.